Ministry of Finance of the Republic of Latvia

Convergence Programme of the Republic of Latvia 2006-2009

January 2007

Contents

1. Overall Policy Framework and Objectives

Latvia's Convergence Programme clearly reflects the objective of the Latvian government to ensure compliance of the fiscal policy with the Stability and Growth Pact and to become a full-fledged Member State of the European Economic and Monetary Union.

The goal of the government's economic strategy is to ensure an improvement of the welfare of population by achieving convergence with the average EU level within a foreseeable period.

In order to attain the above, Latvia needs to preserve high and sustainable economic growth. The key economic policy areas to achieve these objectives are:

- ensuring macroeconomic stability;
- stimulation of knowledge and innovations;
- creation of a favourable and attractive environment for investment and work;
- promotion of employment;
- improvement of education and skills.

One of significant instruments for promoting economic development is implementation of a sound fiscal policy. The task of the government within the framework of the fiscal policy is to achieve a maximum balance between the amount and structure of the government's budgetary revenue and expenditure, favourable to economic development. Based on the Declaration of the intended action of the Cabinet of Ministers and the Macroeconomic Development and Fiscal Policy Guidelines 2007–2011, the Convergence Programme defines the following most important fiscal policy tasks:

- implement a fiscal policy aimed at stable macroeconomic growth; ensure consistent movement towards formulation of a balanced general government budget in the medium-term, preserving low government debt and reducing inflation;
- starting from 2008, introduce medium-term planning of the state budget, ensuring that funding is linked to the strategic plans of ministries and regions and planning the budgetary spending by territories, thus achieving more efficient and effective spending of the state budget;
- ensure long-term sustainability of public finances.

2. Economic Outlook

2.1. Current Economic Development

Integration into the European Union and the implemented national reforms have a favourable effect on the economic development. During the last five years, the annual economic growth averaged 8.1%, amounting to 10.2% in 2005. Vigorous economic growth continued in 2006. In the first 9 months of 2006, the GDP grew by 11.9% year-on-year.

The buoyant economic development was primarily driven by the persistently expanding domestic demand. Foreign trade turnover was increasing as well. The exports growth rates exceeded those of the imports in 2005, and the current account deficit of the balance of payments improved. The year 2006 was marked by a particularly high rise in the domestic demand, and the services sector was a major contributor to the growth of investment. Such circumstances secured pre-conditions for high imports growth rates, whereas the exports expanded at a more moderate rate. Therefore, the current account of the balance of payments was deteriorating, as well as affected by unfavourable terms of trade for Latvia.

Private consumption was supported by rising employment and a high increase in the real income of population. Private consumption was also affected by the expansion of lending against the background of the low interest rates. Favourable economic conditions also increased consumer confidence, which, in turn, induced higher consumption and the willingness of the population to improve their quality of life quicker.

Real growth of **investment** amounted to 18.6% in 2005, and the same trend continued in 2006. Alongside with the increased demand for investment opportunities, the investment deflator was also relatively high. In the first nine months of 2006, net foreign direct investment in Latvia grew twofold year-on-year.

The trade deficit increased to 26.4% of GDP in the first nine months of 2006, with the growth rates of **imports** exceeding those of the **exports**. Exports were still dominated by wood and articles of wood, base metals and articles of base metals, machinery and mechanical appliances, electrical equipment. The growth in exports of products of chemical and allied industries was notable at 43.7%, with exports of plastics products increasing by 36.1% and those of base metals and articles of base metals by 32.5%. In the first nine months of 2006, imports were dominated by machinery and mechanical appliances, electrical equipment, mineral products and transport vehicles. Largest growth was reported in imports of transport vehicles and construction materials.

Analysing the economic development based on the **value added by sectors**, services and construction remained the main contributors to the economic growth in the first nine months of 2006. The highest growth rate was reported by the retail and wholesale sector, posting an 18.5% growth in the nine months of 2006. Construction expanded by 14.8% in the nine months of 2006. Business services grew by 17.6%, financial services by 12.9%, whereas hotels and restaurants expanded by 12.8%. Transport and communications expanded by 9.8% in the nine months of 2006. In industry, the growth rates were moderate (6.8%) although the sector was marked by a transition to production of higher value added products, while the local producers were significantly affected by the external competition conditions.

Inflation averaged 6.7% in 2005, mainly on account of rising food prices with the price catch-up process continuing, and of growing energy prices. In 2006, the inflation growth gradually decelerated, yet the increasing prices on food and administered prices resulted in growing consumer prices. More expensive labour and materials also pushed up the producer and construction price indices. The current price rise has a minimum restrictive effect on the growth of the purchasing power of the population, which is sustained by a high increase in wages and salaries and lending.

Labour market indicators improved alongside with the strengthening economic activity. In the third quarter of 2006, the number of employed increased by 7.2% year-on-year, whereas the unemployment rate declined to 6.2% of the economically active population at the end of the third quarter, which was 2.5 percentage points lower than in the third quarter of 2005. The number of employed decreased in the sectors of education, healthcare and social care, public, social and personal services as well as electricity, gas and water supply, while increasing in manufacturing, construction, trade, financial intermediation and other sectors. A slight improvement of the situation at the end of September 2006 was also witnessed with regard to the unemployment rate by region in comparison with the corresponding period of the previous year. The majority of population was employed in trade, manufacturing, agriculture and transport and communication sector.

In the first nine months of 2006, the average **gross wage and salary** of those employed in the economy grew by 23.0%, totalling 305 lats. Such an increase in wages and salaries related to the general economic development, growing consumer prices as well as emigration of labour to the EU Member States where wages and salaries are considerably higher. A higher increase rate of consumer prices within the reporting period notwithstanding, the real increase of the net wage and salary pointed to growing purchasing power of the population. The real increase of wages and salaries amounted to 15.4%. Net wage and salary in the private sector displayed higher year-on-year growth rate in the first 9 months of 2006, yet itself was higher in the public sector.

2.2. Macroeconomic scenario

The medium-term macroeconomic development scenario envisages cyclical economic development. The scenario provides that the economic growth driven by the domestic demand will outpace the potential growth rates in 2005–2007. In the medium-term, several factors on the demand side are expected to lose their effect and the economic growth is expected to stabilise at a sustainable level of potential economic growth.

The macroeconomic development scenario assumes that several objectives established in the National Development Strategy will be attained by implementation of the measures described in the national Lisbon programme. The structural reforms are bound to have a positive effect on the long-term potential growth, particularly on knowledge and innovation promotion, business environment improvement and employment policy measures.

Table 1. Growth and related factors

	ESA code	**2005**	**2005**	**2006**	**2007**	**2008**	**2009**
		millions of lats	rate of change (%)				
1. Real GDP (at 2000 prices)	B1*g	7016.9	10.2	11.5	9.0	7.5	7.5
2. Nominal GDP	B1*g	8937.3	20.4	22.7	17.1	14.0	12.4
Components of real GDP							
3. Private consumption expenditure	P3	4518.0	11.4	17.0	12.1	7.6	7.5
4. Public consumption expenditure	P3	1108.4	2.7	3.0	3.0	2.5	2.5
5. Gross fixed capital formation	P51	2391.9	18.6	18.2	10.5	10.0	9.0
6. Changes in inventories and net acquisition of valuables	P52+P53	24.9	4.4	8.8	8.2	7.1	6.2
7. Exports	P6	3113.4	20.7	8.6	11.6	9.1	8.8

	ESA code	2005	2005	2006	2007	2008	2009
8. Imports	P7	4139.8	13.5	18.0	11.0	8.7	8.1
Contribution to real GDP growth							
9. Final domestic demand		-	13.6	17.6	12.4	9.3	8.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-4.0	0.7	-1.5	-0.3	-0.1
11. External balance of goods and services	B11	-	0.7	-6.8	-1.9	-1.5	-1.3

2.2.1. Real sector

In the medium-term economic growth will be driven by domestic demand; nevertheless, exports will have a significant role in restoring the macroeconomic balance in a longer term. External imbalance of the Latvian economy is growing, and that raises concerns about the possibilities of a quicker adjustment towards achieving a balance, which, in turn, may affect the real sector. At the moment, the current account deficit is fully financed from foreign financial inflows. Yet with the foreign debt and its service costs growing, the borrowing opportunities will become scarcer. Inflation and growing production costs negatively affect Latvia's external competitiveness; yet at the same time it also serves as a catalyst for more rapid structural changes, with the economy passing over to a higher level of technological development and productivity. Taking into account the potential risk factors, the central scenario of the macroeconomic development envisages gradual stabilisation of the economic situation in the medium term.

GDP by expenditure

Private consumption accounts for about 63% of GDP, and its expansion has a significant impact on the GDP growth. Private consumption increases mainly as a result of growing population income and employment as well as lending expansion. Long-term developments of wages and salaries depend on productivity growth; nevertheless, in 2006 and 2007 the real increase of wages and salaries will exceed the productivity growth for a short period of time as a result of cyclical fluctuations of the economy, including rapidly decreasing unemployment rate. The current monetary conditions favour consumption and investment and do not stimulate accumulation of savings. Consumers borrow to buy durable goods. The behaviour of consumers is driven by optimism stemming from improving financial position and employment as well as confidence in the success of further economic development. Growing assets prices raise the welfare of the population, and part of the increase in the asset value is used for consumption. The share of foodstuffs in the composition of consumption is shrinking, although food and non-alcoholic beverages account for about 1/3 of the total consumption. The share of expenditure relating to transport, recreation and culture, restaurants, cafes and hotels in consumption is expanding.

In the medium term, a moderate increase of private consumption can be expected, and it will be in line with the GDP growth rate. The real increase of wages and salaries will harmonise with the productivity growth. Lending growth will decelerate and the rise in asset value will stabilise, thus decreasing the increase of spending on consumption. It is forecast that in the medium term a larger share of the population's income will be turned into savings and used on making productive investment.

According to forecasts, the real growth of **public consumption** will be moderate in the medium term and comparable with the results of the previous year.

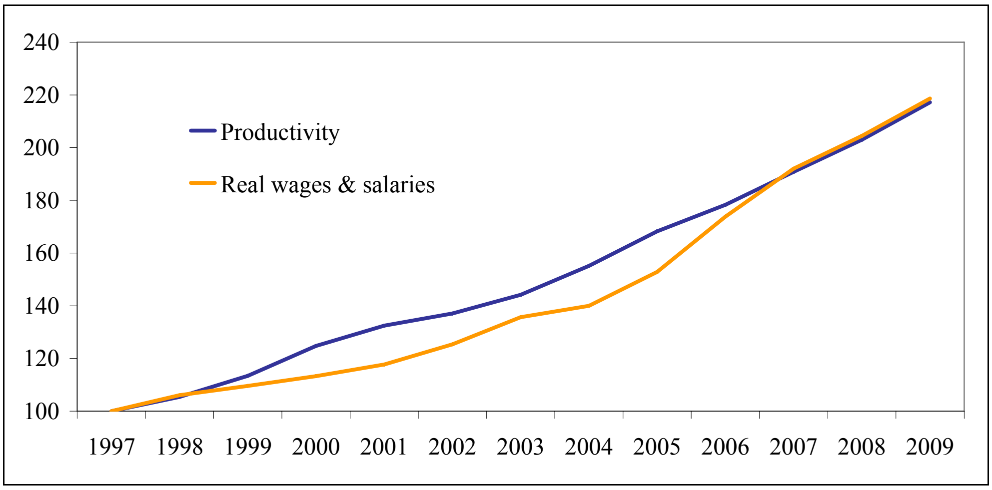

Chart 1. Increase of productivity and real wages and salaries (1997=100)

Gross fixed capital formation has displayed high growth in the last years. Investment accounts for about 1/3 of the GDP and points to a very dynamic process of modernisation in the economy. Nevertheless, high demand for investment objects has pushed up the prices, which may decrease the amount of real investment and their return. Investment is expected to continue to grow in the medium term, as it is necessary to expand the productive production capital, there is a high demand for larger residential spaces, sizeable investment in infrastructure is also required. Financing from the EU funds serves as an additional incentive for investment and the objective of the government is to make the most of the opportunities offered by this financing. Investment is to a large extent dependent also on the level of domestic savings. Stabilisation of the real estate market could increase the attractiveness of investment into the production sector.

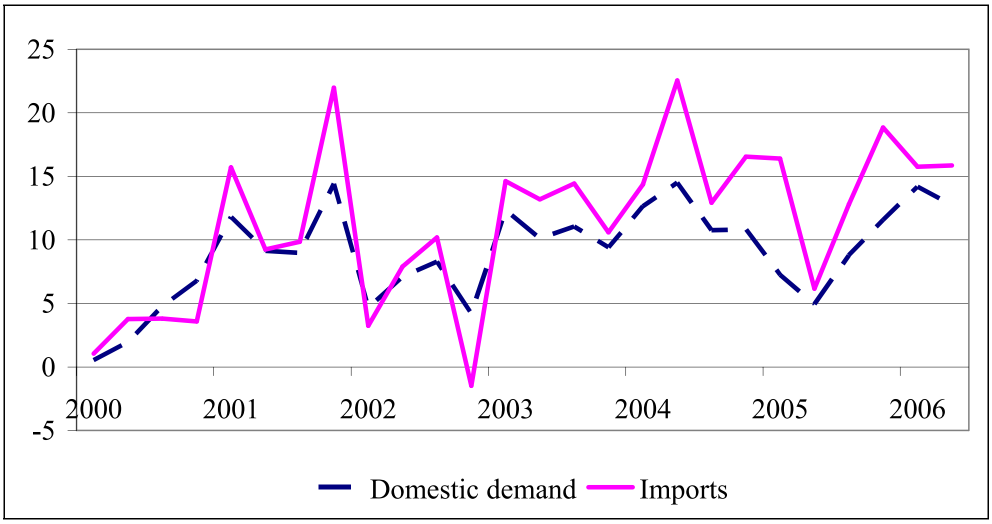

Chart 2. Growth of domestic demand and imports (%)

Considering the size of the Latvian economy and its openness to external trade, a further increase in **foreign trade** turnover can be expected. Export growth was particularly dynamic in 2005, yet in 2006 the high domestic demand dampened the producers' need for expanding the export market. In 2006, the trade deficit of goods is expected to grow to 25.3% of GDP, although the surplus of services trade is improving and is forecast to amount to 5.1% of GDP. Annual actual export growth will exceed 10% in 2006 and beyond, which is a very high result in producer market. Export growth will continue to be driven by further investment into production capital, enabling transition to production of higher value added outputs, as well as by the economic policy measures of the government aimed at promotion of exports.

Import growth is sustained by high domestic demand for both consumer and investment goods. The share of imported raw materials is also high in production of export goods. Import growth is explained also by the growth of prices on imports, which in 2005 and 2006 was driven by rising global prices on mineral products and base metals. In the medium term, the impact of growing import prices should fade away, except for a rise in prices on particular energy resources.

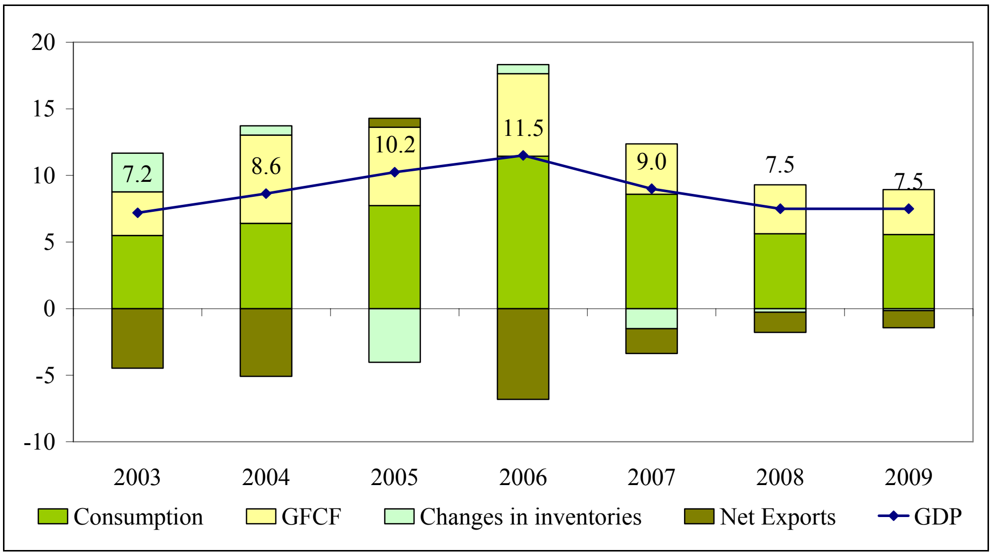

Chart 3. Contribution to GDP growth (%)

GDP by sector

The growth of **industry** is lower than that of the GDP, as this sector is widely open to international trade. The development of the sector is largely dependant on export opportunities and the prices of export goods in the major export markets. At the beginning of 2005, the demand for Latvia's woodworking products in Europe was dampened as a result of the storm. Rough global competition in two export sectors (woodworking and production of textiles) that are important to Latvia determined low prices on export products or even their decline. That, in turn, diminished the returns from manufacturing of those products and prevented the output from growing. Development is more successful for the branches of industry experiencing price rises. In food industry, base metals and metal working, chemical industry prices are on a rise both on the domestic as well as external market, and that promotes the development of these sectors.

In the medium term the producers will tend to start producing technologically more complex products that are less subject to price competition. That could be achieved by modernisation of production processes, labour force improvement and larger investment in creation of new products. Development of the branches of industry will be facilitated by various governmental economic policy measures aimed at developing the capacity of businesses, production of higher value added goods and promotion of innovations.

Construction sector has been reporting very high growth rates already for several years. In 2005, construction expanded by 15.5% at constant prices, despite of the high price rise by 11.5%. The rapid development of the real estate market in the last years has created a very high demand for housing construction, and this sector displays the highest growth rates. The major contributors to the overall growth and also characterised by buoyant development are the sub-sectors of construction of non-residential buildings and civil engineering constructions. In the medium term, the growth of the volume of construction in both construction of new buildings as well as in renovations is expected to remain high. The demand is high in all sectors of construction. Driven by demand, costs are growing, and it stimulates a more rapid development of the construction services supply. The construction sector also has a high potential for productivity growth and it could materialise through improving technologies and logistics.

The development of **agriculture** is highly dependant on weather conditions. The atypically dry summer of 2006 resulted in a broadly-based decline in agricultural crops, and according to the estimates prepared by experts of the sector crop farming has probably harvested 40% less than in other years. The overall decline of the sector of agriculture, forestry and fishing could amount to 3.3% year-on-year in 2006. Nevertheless, the revenue of the sector at current prices will grow in 2006 on account of the price rise for agricultural products.

Provided that there are no contingency effects, agriculture will experience positive output growth in the medium term, and the prices on outputs will catch up with the average prices of other EU Member States. It is expected that the number of persons employed in agriculture will continue to decrease, *inter alia* under the impact of demographic factors. The medium-term and long-term development of the sector will be driven by the development of the Common Agricultural Policy of the EU and potential reforms. More moderate growth of the sector will be also determined by slower growth of forestry, as the optimum volume of timber cutting has been almost reached and further development of the sector will be driven by increasing efficiency.

Private services sectors account for about 60% of the total value added and are major contributors to the overall economic growth. Trade sector has been marked by rapid development already for several years, which is in line with the growing private consumption and the development of consumer behaviour. Transport and communication sector is characterised by moderate growth in freight transportation or even a decline for some types of transportation, whereas the overall growth of the sector is driven by rapid development of communication services. In the medium term, more moderate growth rates of trade can be expected against the background of market saturation, whereas the transport sector could be fostered by the expansion of Latvia’s external trade, growing exports to the CIS countries and global trade developments.

Business and financial services display higher growth figures alongside with increased overall economic activity. These sectors benefit from the rapid lending expansion and heightened interest of the population about the real estate market. In the medium term, the financial market will mature and offer increasingly wider types of services. Several specialised types of services will develop in the area of real estate and business services.

Public services sectors usually report low growth rates at constant prices, yet higher growth rates at current prices. This relates to the high labour force intensity in those sectors and limited opportunities to raise productivity by means of capital investment. Similar development trends will persist in the medium term, while the sectoral growth will be supported by demand for better quality services.

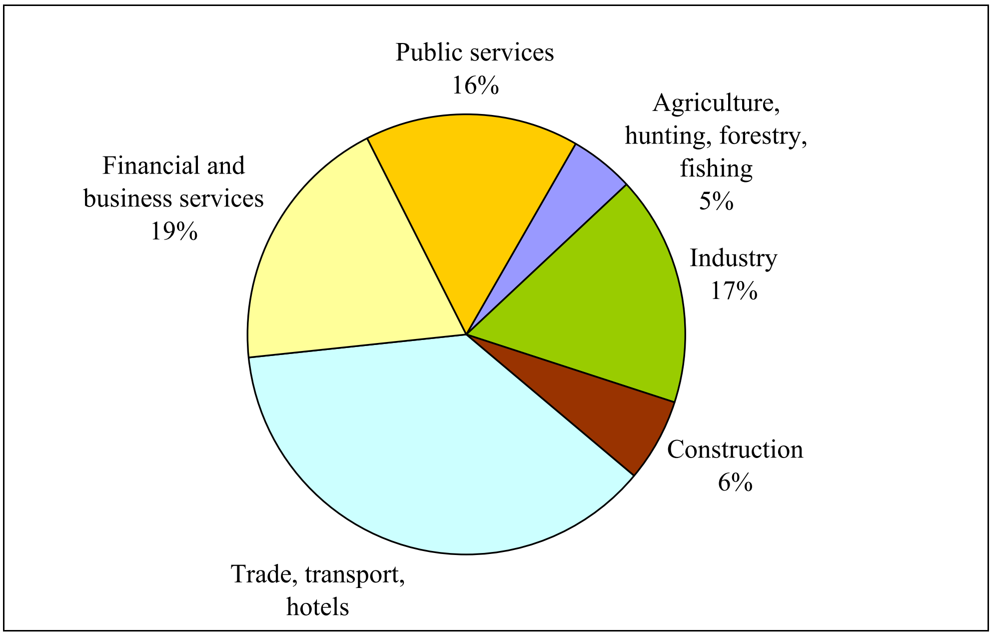

Chart 4. Value added by sector in 2005 (%)

Labour market

Latvia's population continued to decrease in 2005, shrinking by 0.5%. As a result of natural movement, population declined by 11.3 thousand during 2005, whereas due to migration by 0.6 thousand.

2005 was marked by the highest birth rates within the last 10 years, with 21.5 thousand children born, which is 1.2 thousand children more than in 2004. Birth rates are on a rise in 2006 as well. In the first eight months of 2006, 14.7 thousand children were born, which is 0.6% more year-on-year. Yet as a result of the death rates still exceeding the birth rates, in combination with the negative net migration, the population in Latvia will gradually decrease. Analysis of the demographic trends by age profile up to 2009 leads to a conclusion that the number of working-age population will decrease at a lower rate than the overall number of population.

Economic activity is growing year-by-year, and Latvia approaches the medium-term target for employment set in the Lisbon strategy. Yet regardless of the positive trends in the area of the economic activity, the medium-term growth of the number of employed will be increasingly more restricted by the impact of demographic factors.

In the last years, the increase in the number of employed has been very high both as a result of decreasing unemployment and economic activity growth. On average, a high increase in the number of employed is expected in 2006; nevertheless, in the years to follow the employment growth will gradually decelerate. Overall economic growth in Latvia is mainly underpinned by productivity growth; therefore, a lower increase of the number of employed will have no significant impact on the overall growth.

Of late, there is an increasingly smaller difference between the official registered unemployment and unemployment figures resulting from surveys. The macroeconomic development scenario provides for further decrease in unemployment, promoted by economic activity growth and employment policy measures.

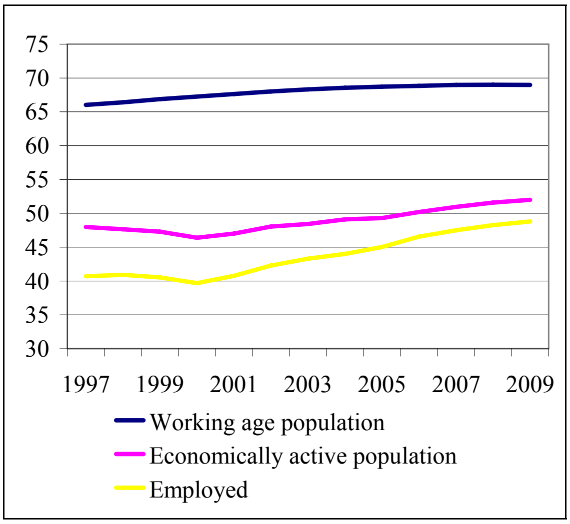

Chart 5. The ratio of working-age, economically active and employed population to total population (%)

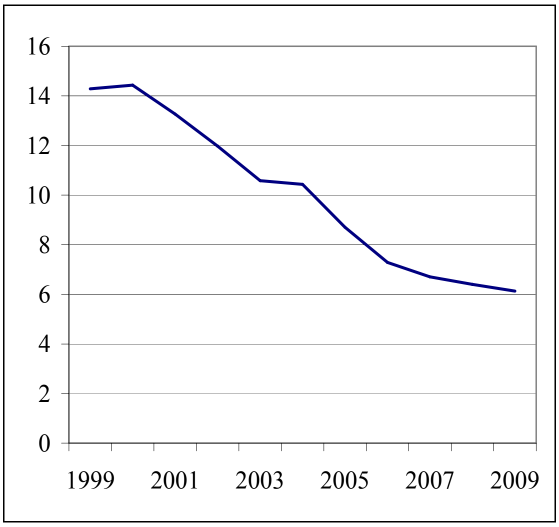

Chart 6. Job-seekers (% of economically active population)

In 2006, the average gross wage and salary in the economy could increase by 21.1%, whereas in 2007 by 17.6%. Such an increase would exceed the correlation between the real wage and salary and productivity growth, yet in the short-term these developments would pose no threat to the overall competitiveness of Latvia. There are several factors behind the recent rapid increases in wages and salaries: persistently high inflation, decreasing supply of labour force, alternative employment opportunities abroad, and activity of controlling institutions as well as rising of the minimum monthly wage. The increase of the real wage and salary is expected to be in line with the productivity growth in the medium term and will be about 6%–7%.

2.2.2. Inflation

In 2005, Latvia's inflation amounted to 6.7%. It remained high also in 2006, although a gradual month-on-month decline to 5.6% in October 2006 was observed. Nevertheless, the growth of inflation in the last months of the year did not allow the average annual inflation for 2006 to decrease below 6.5%.

In 2006, the prices on unprocessed foodstuffs contributed 1.1 percentage points to the overall inflation, with the respective figures for the impact of administered prices being 1.6 percentage points, whereas the fuel prices compressed the inflation rate by 0.1 percentage point. Core inflation amounted to 4.2 percentage points.

Fuel price dynamics was driven by oil price developments as well as the high base of the previous year. Administered prices were on a gradual rise since the beginning of the year, when the new natural gas tariffs were introduced in January, electricity tariffs were raised in March, while in May another rise in natural gas tariffs followed. More expensive energy resources, largely reflected by prices on imports, resulted in an increase in other administered prices (transportation services and a gradual rise in heating tariffs). Rising prices created the indirect impact on inflation as well, as they constitute a significant part of costs in other sectors.

Developments of the prices of unprocessed foodstuffs partly relate to rising energy costs and other costs. The weather conditions also resulted in poor harvest; therefore, the prices on cereal products (including bread prices) grew in the second half of the year.

The relatively high core inflation stemmed from a rise in prices of some raw materials and energy as well as other costs (e.g., considerable increase in wages and salaries in the overall economy). Contrary to the decelerating growth of prices on goods, the annual growth rate of services prices remained stable. Although the high inflation rate in Latvia can be partly explained by the supply side shocks, it is also significantly influenced by the strong domestic demand, the economy exceeding the potential level of output and tight labour market conditions. This is confirmed by the stable and growing corporate profit margins in almost all sectors of the economy, regardless of the significant increase in costs and higher unit labour costs.

The y-o-y inflation rate is expected to decrease by more than 1 percentage point over 2007, yet the average annual inflation will remain broadly unchanged at 6.4%. Specific plans of significant increases in administered tariffs (electricity, natural gas, public transport etc.) in 2007 are already in the pipeline. Similarly, raising of the excise tax rates imposed on tobacco products and fuel will also push up the overall inflation rate. It has to be noted that the schedule for raising the excise tax rates on tobacco products was changed in December 2006, providing that the minimum rates set by the EU will be reached in 2009, a year sooner than stipulated by the provisions of the EU Accession Treaty; therefore, the inflation forecasts (particularly for 2007 and 2008) had to be revised upwards.

The forecasts of the medium-term inflation have been made taking into account the inflation being fuelled by the expected rises in energy prices, i.e. higher electricity tariffs for all consumers, increased prices on natural gas and heating. Tight labour market conditions may also cause a further increase in unit labour costs. Inflation expectations and second-round effect will also have some impact. These factors will also influence the core inflation and will not let it decrease rapidly. Yet at the same time, the expected macroeconomic development scenario creates pre-conditions to deceleration of the price dynamics as a result of a positive output gap and easing pressure of consumption on inflation, and at the same time a higher base and growing competition, which will have an especially dampening effect on the growth of the prices of industrial goods. Global oil prices and, consequently, fuel prices are expected to stabilise. The scenario also assumes that the weather conditions in the years to follow will have a neutral effect on crops. The scenario provides for improvement and medium-term implementation of inflation restricting government policy measures. At the same time, the lending policies of commercial banks will also tighten against the background of growing concerns about creating a more balanced loan portfolio, and the euro rates are expected to grow in line with the ECB policy. Consequently, the consumer price rise could decelerate to 5.2% in 2008 and 4.2% in 2009. Such inflation rates would be slightly higher than in the neighbouring countries, thus catching up with the living costs of the region where Latvia's prices were amongst the lowest so far.

Table 2. Changes in consumer prices

	2005	**2006**	**2007**	**2008**	**2009**
	actual	forecast			
HICP changes (year-on-year)	6.9	6.6	6.4	5.2	4.2
CPI changes (year-on-year)	6.7	6.5	6.4	5.2	4.2

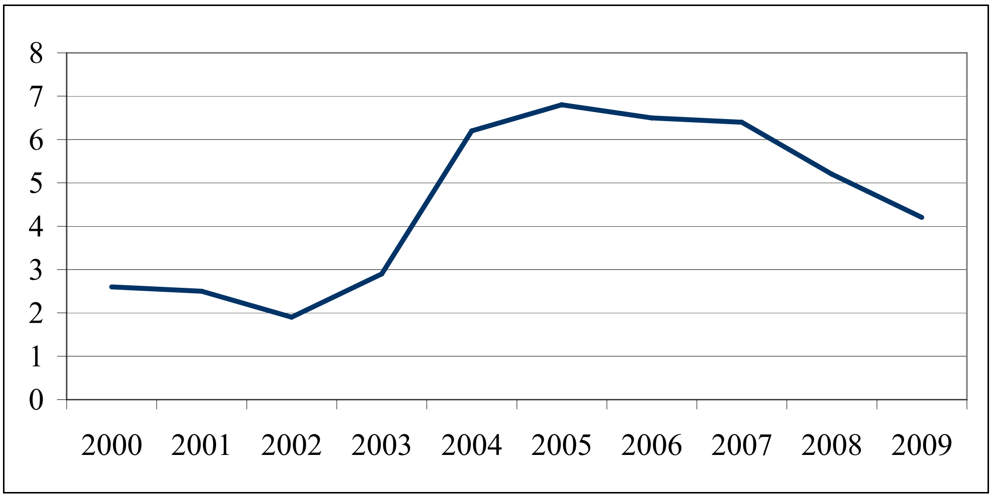

Chart 7. Consumer price index developments in 2000 –2009 (%)

2.2.3. Monetary and Exchange Rate Policy

Latvia's medium-term monetary and exchange rate policy largely relates to the monetary integration plans. Latvia joined the ERMII on 2 May 2005, undertaking a unilateral commitment to ensure a +/-1% exchange rate fluctuation corridor around the central parity rate (EUR 1 = LVL 0.702804). Duration of participation in the ERMII will depend on the ability of Latvian economy to meet the convergence criteria and the evaluation of the involved institutions of Latvia's readiness to join the Economic and Monetary Union.

In order to implement the monetary policy effectively and without shocks to the financial sector, the Bank of Latvia adjusts monetary policy implementation instruments to the European Central Bank practice. Currently, the Bank of Latvia already uses the same indirect monetary policy instruments based on free market principles as the ECB and in the future, when joining the EMU, only the significance of some instruments in implementation of the monetary policy and procedural elements will have to be reviewed.

In order to mitigate the macroeconomic risks relating to the rapid economic growth of Latvia, lending expansion, high inflation and excessive current account deficit, the Bank of Latvia continued to implement a tight monetary policy at the end of 2005 and in 2006. In December 2006, the minimum reserve requirement for banks was raised from 6% to 8%. In May 2006, the minimum reserve base for banks was expanded to include bank liabilities with an agreed maturity of over 2 years. Along with the euro zone interest rates increasing, the Bank of Latvia also raised the refinancing rate on two occasions in July and November 2006, overall from 4% to 5% or by 100 basis points. In order to restrict the liquidity of the banking sector, the Bank of Latvia sold its portfolio of government securities and accumulated all of the Treasury's time deposits in lats within the central bank.

2.2.4. External sector

Table 3. Key items of the balance of payments (% of GDP)

% of GDP	ESA code	**2005**	**2006**	**2007**	**2008**	**2009**
1. Net lending/borrowing vis-à-vis the rest of world	B.9	-11.4	-17.4	-17.2	-16.3	-15.8
Of which.: - Balance of goods and services		-15.3	-20.8	-20.7	-20.0	-19.3
- Balance of primary income and transfers		2.6	2.1	2.2	2.3	2.1
- Capital account		1.3	1.3	1.3	1.4	1.4
2. Net lending/ borrowing of the private sector	B.9/ EDP B.9	-11.5	-17.0	-15.9	-15.4	-15.4
3. Net lending/ borrowing of the general government sector	EDP B.9	0.1	-0.4	-1.3	-0.9	-0.4
4. Statistical discrepancy		-2.0	0.0	0.0	0.0	0.0

The current account deficit of the balance of payments has increased significantly during the last years in Latvia. On the one hand, the persistently high current account deficit is determined by the convergence process and the use of foreign savings to finance modernisation and development of the economy. On the other hand, cyclical factors have also exerted an upward pressure on the current account deficit of late, with Latvia's economy performing above the level of the potential output. Favourable financing terms and acceleration of the growth of private consumption prevent the domestic savings from expanding. With domestic prices and wages and salaries increasing notably, the previously favourable cost-competitiveness of enterprises gradually deteriorates. External factors also have been unfavourable, with the terms of trade worsening mainly on account of the rapidly growing energy prices and with external demand in some export markets significant for Latvia shrinking.

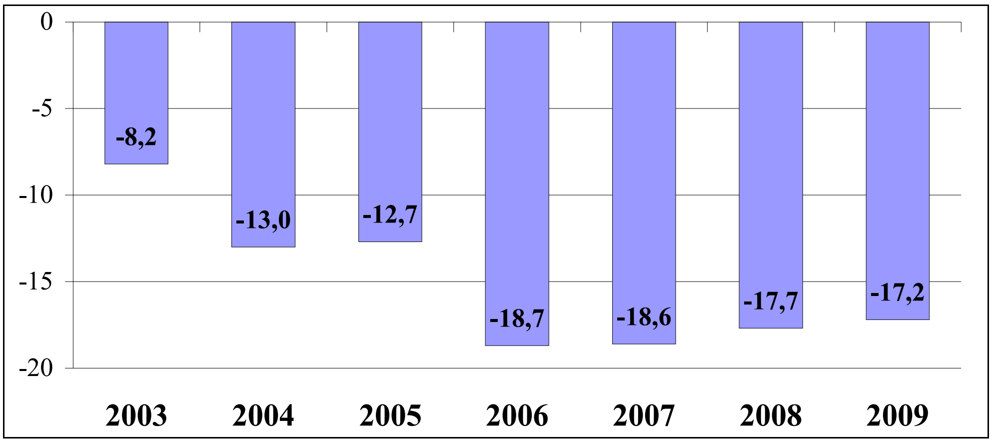

Chart 8. Current account deficit (% of GDP)

In 2005, the current account deficit amounted to 12.7% of GDP. Although in 2005 the external trade developed buoyantly (the growth of exports of goods exceeded that of the imports, thus slightly improving the balance of trade), in the second half of the year gradual deceleration of the exports of goods started, which continues also in 2006. The growth rate of the imports of goods, on the contrary, remains high. As a result, the balance of trade continues to deteriorate, and its is the main component behind the current account deficit.

Exports of goods decelerated from 34.3% in 2005 to 14.0% in nominal terms in the first nine months of 2006 on account of a slight decline in exports of wood and articles of wood (Latvia's major export goods) under the impact of lower external demand, low export prices and high domestic demand. It was also determined by falling exports of mineral products as a result of the high base of the previous year, which was mainly underpinned by changes in statistics methodology. Although currently the impact is yet insignificant, deterioration of the international cost-competitiveness also dampens the export growth, creating risks to medium-term development of the exports. The growth of imports of goods, on the contrary, remained high in nominal terms, amounting to 30.2% in the first nine months of 2006 in comparison with 27.9% in 2005. It was driven by both the strong domestic demand which was additionally fuelled by implementation of such large investment projects as restoration of *Latvijas Kuģniecība* fleet and reconstruction of TEC2 started by *Latvenergo* and rising prices on imports.

The balance of services is with a surplus in Latvia and covers about 1/5 of the deficit of the balance of goods. In the first nine months of 2006, exports of services increased by 25.2%, whereas the respective imports by 23.7%. The surplus of the balance of services grew mainly on account of increasing exports of transportation services and, to a lesser extent, by exports of travel services. The surplus of transportation services expanded mainly as a result of growing freight transportation by road and by rail. In the third quarter of 2006, the surplus of the balance of services shrank, as imports of services expanded at a higher rate.

The income deficit grew twofold in the first nine months of 2006 in comparison with the corresponding period of the previous year, with non-resident investment income gained in Latvia from direct investment and other investment rising rapidly. The increase in compensation to employees received by residents abroad offset only 1/4 of the non-resident income growth. The surplus of current transfers has remained broadly unchanged in comparison with the first nine months of 2005.

The financing structure of the current account deficit points to foreign investors' confidence in further economic growth and government policy implemented in Latvia. Rapid economic growth, accession to the EU and favourable geographical position help to secure foreign direct investment inflows into Latvia. In 2005, net inflows of foreign direct investment amounted to 3.8% of GDP, whereas in the first nine months of 2006 to 7.0% of GDP. Overall, in the last years the current account deficit was fully covered by foreign direct investment and other long-term capital (mainly long-term bank loans from parent banks abroad). The capital account surplus also continues to grow, which can be explained by the inflows of the EU funding in Latvia. Reserve assets increased significantly in 2006, which was additionally supported by the Bank of Latvia's policy to raise the minimum reserve requirement. In the next years, the FDI and banking sector borrowings abroad are expected to continue to be the main financing source for the current account deficit.

The trends so far suggest that the current account deficit of the balance of payments will exceed 18% of GDP in 2006. It is expected that the terms of trade will improve in the medium term, with import unit prices approaching the inflation rate reported in the major trade partner countries. Improved export capacity through adjustment to the terms of external trade and production restructuring towards manufacturing of higher value added goods will promote the growth of exports. Although gradual deceleration of the domestic demand is expected in the next two years, it will remain strong and will sustain the demand for imports at a high level. In 2009, against the background of decelerating domestic demand and improvement of the balance of trade, the current account deficit is expected to decline to 17.2% of GDP. In comparison with the private sector, the balance of government investment and savings has a minor effect on the overall current account deficit, yet the planned reduction of the government deficit will have a positive effect on it.

2.3. Economic impact of the structural reforms

The structural reforms discussed in Latvia's national Lisbon programme are closely related to Latvia's National Development Plan, which is a medium-term planning document. Reform implementation will improve the economic growth potential and contribute to attainment of the main objectives set in the National Development Plan. The reforms also have a positive effect on sustainability of public finances.

Latvia's national Lisbon programme focuses on the following areas of structural reforms:

- stimulation of knowledge and innovations;
- creation of a favourable and attractive environment for investment and work;
- promotion of employment.

Measures to promote **knowledge and innovations** provide for an annual increase of public spending on scientific activity by at least 0.15% of GDP. Significant modernisation of scientific infrastructure in scientific institutes and universities is planned as well as reorganisation of the national scientific institutes. Cooperation of Latvian scientists and businesses, particularly, SMEs, in research required for the development of new technologies and products is encouraged.

Progress with regard to increasing numbers of internet users points to development of information society. Implementation of the current policies has secured a very good telecommunications network, ICT related legislation has been aligned, main registers and the most significant information systems have been established, integration of the public administration IS and establishment of on-line services is in progress.

Improvement of business environment is effected through lessening the administrative burden, promoting a dialogue among business organisations as well as delivering training, consultations and providing financial support to businesses. An Action Plan for Improvement of Business Environment is prepared every year. 2006 Action Plan addresses the problems relating to construction, employment, tax administration, introduction of e-administration etc. In 2005 and 2006, the performance of the Register of Enterprises was improved, a new Solvency Law was drafted. A priority in the area of protection of competition is fighting the most significant violations of the Law on Competition, e.g. conclusion of forbidden agreement and abuse of the dominant position. On order to implement that, amendments have been introduced in the Law on Competition, Cabinet of Ministers regulations providing for the so-called Tolerance programme in application of fines have been adopted.

In order the improve availability of funding for the SMEs, more attention is paid to granting funding to business development at very early stages and to availability of financing in the form of venture capital as well as to co-financing extended to business development project in special support territories. During the next financial perspective period, financial support to businesses and innovations in the amount of 480 million euro is planned from the structural funds.

Energy policy is one of the top priorities among the business environment policies. The government has adopted the Energy Development Guidelines 2007–2016 providing for several strategy measures to decrease the energy dependence of Latvia, including the construction of a new electricity plant in Latvia and increasing the use of renewable energy resources (especially biomass) in energy production. Latvia is about to open the common electricity market to all customers, and it will be opened by mid-2007. The domestic gas market, in turn, will be opened by 2010. Thus competition on the energy market will be ensured.

Considering the policy implemented by the EU in the area of reducing climate changes and the energy supply security issue which is important for Latvia, making use of sustainable energy resources is one of the national priorities. Therefore, the government supports the measures to raise the energy-efficiency, use of cogeneration and renewable energy resources as well as promotes the development of environment technologies.

Latvia's **employment policy** is formulated on the basis of the following priorities:

- promote an inclusive labour market by expanding the range of active employment measures;
- stimulate economic activity in under-developed regions;
- address more intensively the problem of undeclared employment and encourage the population to work in the formal economy by raising the net wages and salaries for low-income population and by enhancing both the state control institutions and associations of the social partners (trade unions, employee associations etc.);
- expand education and training opportunities.

Preventive measures for promotion of employment and reduction of unemployment include vocational training, re-qualification and improvement of the qualifications of the unemployed, including provision of the state language training. Particular attention has been paid to measures relating to inclusion of young people, pre-retirement age population and women (especially after the period childcare leave) as well as the disabled and other socially-marginalised risk groups into the labour market.

Support to business development in territories requiring special assistance is provided within the framework of both the national financing (Regional Fund) and the EU funding (European Regional Development Fund), thus promoting the economic activity in those regions, creating new jobs and preserving the existing ones. Growing activity of business people and the achieved performance indicators point to increasing business activity in the territories requiring special assistance. Therefore, for the programming period 2007–2013 a new programme for support to business activities in territories requiring special assistance has been prepared within the framework of the European Union's structural funds.

With a view to increase the economic activity in underdeveloped regions more effectively, a more rapid increase of budget spending on improvement of the 2nd class roads is planned. For 2006, provisions in the amount of 3.5 million lats have been made, and in the years to follow the planned allocations amount to 12 million lats.

The problem of undeclared employment is addressed using a broadly-based approach. The administrative capacity of the State Labour Inspection is raised, the role of trade unions and employer associations is increased and the minimum wage and non-taxable minimum are raised, in order to lighten the tax burden on low wages and salaries.

As of 1 January 2006, the minimum monthly wage and salary has been raised from 80 to 90 lats and the minimum amount exempt from personal income tax has been increased from 26 lats to 32 lats per month. As of 1 January 2007, the minimum wage and salary has been set at 120 lats and the non-taxable minimum at 50 lats.

Improvement of education and skills is an important component of the employment policy, with the main tasks being:

- to strengthen the cooperation among public administration institutions, educational establishments and employers, in order to adjust the education system's supply to the labour market needs;
- to raise cost-efficiency at all levels and in all types of education;
- to improve the accessibility of all level education and reduce the number of drop-out students failing to graduate or receive professional qualifications;
- to increase the accessibility of life-long education and the motivation of the population in this area;
- to improve the overall level of technological skills and knowledge of natural science, improve the system of career guidance and ensure the accessibility of career guidance services to all population in the context of life-long education.

3. General Government Balance and Debt

3.1. Fiscal Policy and General Government Balance

The fiscal policy implemented by the government is aimed at stable macroeconomic growth, ensuring gradual improvement of the fiscal outlook. A significant task of the government's fiscal policy is creating a balanced budget. It is forecast that the general government deficit will decrease gradually in the medium term. For the purpose of successfully attaining the above objective, ministries introduce strategic planning, which will ensure that the budget is orientated towards financing of objectives and results.

The task of the government within the framework of the fiscal policy is to achieve a maximum balance between the amount and structure of the government's budgetary revenue and expenditure, favourable to economic development.

The main tasks of the fiscal policy implemented by the government are as follows:

- the government's budget expenditure policy must be aimed at economic development and addressing social problems;
- gradual reduction of the general government deficit;
- ensuring long-term sustainability of public finances.

Latvia's government has defined the following public spending priorities for the 2007 budget:

- creation of a functioning healthcare system, based on ensuring access to high quality healthcare services to all population;
- overcoming the crisis in the system of interior affairs by creating an effective internal security system;
- improvement of the education system orientated towards the needs of knowledge economy development and formation of a knowledgeable, creative and purposeful personality;
- modernisation of the social security system, ensuring its accessibility to population of various social layers and economic opportunities;

- raising the administrative and institutional capacity of law enforcement institutions, creation of a transparent internal control and oversight system;
- effective planning and spending of the national EU funds and EEA funding, ensuring timely project implementation and attainment of the set objectives;
- transition of the defence system to professional armed forces, ensuring the implementation of national security protection tasks, high quality implementation of commitments undertaken through international and inter-state agreements in a professional manner;
- creation of a high quality and modern cultural infrastructure, providing for the cultural needs of the society and increasing the awareness of culture as a full-fledged component of the knowledge economy;
- modernisation of the public administration system and its capacity, improving the professional qualifications of employees and consistently implementing a gradual introduction of a universal pay system throughout the public sector.

The currently ongoing reforms aimed at increasing the performance efficiency of the healthcare and interior affairs system are expected to continue in the medium term. Spending will be increased on national defence, security and NATO participation and co-financing for the European Union funding will be provided.

In 2007, the general government deficit is forecast at 1.3% of GDP. In the medium term, a gradual decline of the general government deficit to 0.4% of GDP in 2009 is forecast. Provided that gradual reduction of the budgetary deficit continues, Latvia is expected to achieve a balanced budget in 2010.

Table 4. General government budget (millions of lats)

	2005	2006	2007	2008	2009
	actual	estimate	forecast		
Revenue	3232.8	4112.0	4905.7	5650.2	6414.9
Expenditure	3221.2	4150.6	5072.6	5781.9	6480.7
Balance	11.6	-38.6	-166.9	-131.7	-65.8

The general government deficit is primarily dependent on the deficit in the central government budget. According to forecasts, in the medium term the central government deficit will decline gradually from 2.7% of GDP in 2007 to 1.5% of GDP in 2009. A gradual reduction of the central government deficit is forecast because:

1) it is necessary to continue the ongoing reforms in the areas of interior affairs and healthcare;

2) expenditure in the amount of 2.0% of GDP has to be planned in the central government budget for national defence, security and NATO participation.

3) it is necessary to ensure the pre-financing and national co-financing for drawing financing from the European Union funds, agricultural policy and European Community programmes and initiatives;

4) additional financing is required to ensure implementation of international agreements and the EU legislation as well as to build the administrative capacity.

Nevertheless, in order to achieve a balanced budget, the government has undertaken to improve the expenditure planning policy, with a view to restricting the growth of expenditure in the medium term.

The financial position of the social security budget has improved significantly in the last years. If in 2002 this budget ran a surplus in the amount of 0.3% of GDP, in 2005 the surplus amounted already to 1.3% of GDP. In the medium term, the social security budget will preserve a surplus; nevertheless, it will decline from 1.8% of GDP in 2006 to 1.0% of GDP in 2009. Shrinking of the surplus will be driven by a decrease in the size of social security contributions, as social security contributions to the funded pension scheme will grow. At the same time, several amendments to legislation were introduced in 2005, which will impact on the social security budget expenditure in the medium-term.

<u>The most significant amendments to the Law “On State Pensions”</u>

1) from 1 January 2006:

   - a monthly bonus to the old-age pension is granted to those who receive low pensions. Bonuses to the old-age pension will be granted to those pensioners whose pension is below 105 lats and whose total insurance record is at least 30 years;
   - pension indexation procedure has been changed, stating that up to 31 December 2009 state pensions below a three-fold state social security benefit (LVL 135) will be reviewed twice a year (on 1 April and 1 October). When reviewing the pensions on 1 April, the actual consumer price index will be taken into account, while on 1 October the actual consume price index and 50% of the real percentage increase of social security contribution wage. Pensions over three-fold state social security benefit but below five-fold state social security benefit (LVL 225) will be reviewed annually, on 1 October, based on the actual consumer price index. From 1 January 2010 to 31 December 2014 all state pensions below three-fold state social security benefit have to be reviewed annually, on 1 October, based on the actual consumer price index and 50% of the real percentage increase of social security contribution wage. Pensions over three-fold state social security benefit but below five-fold state social security benefit have will be reviewed annually, on October 1, based on the actual consumer price index and 25% of the real percentage increase of social security contribution wage;
   - the size of the loss-of-supporter pension for each child may not be below 65% (LVL 29.25) of the state social security benefit;
   - the procedure for recalculating pensions has been changed, stating that starting from 1 January 2006, pensions may be recalculated regardless of the number of months that have been worked (currently at least 12 months), whereas starting from 1 January 2007, in cases when a person has worked after having been granted (recalculated) a pension and accumulated pension capital, he/ she may recalculate the pension once every year, regardless of the number of months that have been worked (currently once every three years);
   - the size of the state social security benefit has been increased from LVL 35 to LVL 45. Consequently, the size of the minimum pensions also change accordingly;

2) from 1 January 2007:

   - new old-age pensions are granted to those persons who claimed early retirement, but, without receiving any pension, continued to work until reaching the standard retirement age;
   - the share of pensions withheld from pensioners within the period of 01.01.2000–19.03.2002, because they continued to work, is paid out;

- a bonus to the old-age pension has been provided for those who have worked hazardous jobs if their insurance record is at least 25 years and the size of the pension does not exceed LVL 135 per month;
- a bonus to the old-age pension will be granted to those pensioners whose pension is below LVL 135 (LVL 105 up to 31 December 2006) and whose total insurance record is at least 30 years;
- minimum pensions are recalculated in cases when the amount of the pension to be disbursed to the pensioner not the calculated pension is changed and is lower than the minimum;
- minimum size of the old-age pension is reviewed, providing larger support to persons whose insurance record is at least 41 years;
- in the event of death of a pension recipient, the surviving spouse, based on his/her application, is granted and disbursed a single benefit in the amount of two pensions received by the deceased spouse;
- an opportunity to retire five years earlier is offered to the participants of liquidations of the consequences of the Chernobyl nuclear plant crash and to persons having working in hazardous work conditions.

In 2002, the deficit of the local government budget amounted to 0.9% of GDP. Starting from 2003, the financial discipline of the local governments improved significantly. As a result, the local governments concluded the year 2005 with a small financial surplus. It is expected that the local governments will preserve a financial surplus in the amount of 0.1% of GDP in the medium term. A more rapid increase of the surplus is not expected in the medium term, as the local governments need to continue improvements of the local infrastructure as well as ensure pre-financing for the EU funds. It has to be noted that the process of local government mergers has not been fully completed yet. If the local governments merge more intensively, creating local governments (territories) that are more capable of economic development and financially stronger, the financial development of the local governments could be even more successful in the years to come, as by forming larger local governments it is possible to use the existing funds more efficiently and raise additional funding.

Table 5. General government budgetary prospects

		2005	2005	2006	2007	2008	2009
	ESA code	millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	11.6	0.1	-0.4	-1.3	-0.9	-0.4
2. Central government	S.1311	-109.2	-1.2	-2.2	-2.7	-2.0	-1.5
3. State government	S.1312	-	-				
4. Local government	S.1313	1.7	0.0	0.1	0.1	0.1	0.1
5. Social security funds	S.1314	119.1	1.3	1.8	1.3	1.0	1.0
General government (S13)							
6. Total revenue	TR	3232.8	36.2	37.5	38.2	38.6	39.0
7. Total expenditure	TE	3221.2	36.0	37.9	39.5	39.5	39.4
8. Budgetary balance	EDP B.9	11.6	0.1	-0.4	-1.3	-0.9	-0.4
9. Interest expenditure*	EDP D.41	51.0	0.6	0.5	0.5	0.5	0.5
10. Primary balance		62.6	0.7	0.2	-0.8	-0.4	0.1
Selected components of revenue							
11. Total tax (11=11a+11b)		1840.9	20.6	21.4	21.9	22.3	22.4
11a. Taxes on production and imports	D.2	1126.0	12.6	12.8	13.4	13.7	13.8
11b. Current taxes on income, wealth etc	D.5	714.9	8.0	8.6	8.5	8.6	8.6
12. Social contributions	D.61	777.9	8.7	8.8	8.4	7.7	7.5

		2005	2005	2006	2007	2008	2009
	ESA code	millions of lats	% of GDP				
13. Property income	D.4	63.3	0.7	0.6	0.4	0.4	0.4
14. Other **		550.7	6.2	6.7	7.5	8.2	8.7
15. Total revenue	TR	3232.8	36.2	37.5	38.2	38.6	39.0
Tax burden (D.2+D.5+D.61+D.91 – D.995)***		2645.5	29.6	30.5	30.6	30.3	30.2
Selected components of expenditure							
16. Collective consumption	P.32	779.3	8.7	12.7	14.2	14.4	13.9
17. Total social transfers	D.62 + D.63	796.4	8.9	7.9	7.4	7.4	6.9
17a. Social transfers in kind	D.63	9.6	0.1	0.1	0.1	0.1	0.1
17b Social transfers other than in kind	D.62	786.8	8.8	7.8	7.4	7.3	6.9
18.=9. Interest expenditure	EDP D.41	51.0	0.6	0.5	0.5	0.5	0.5
19. Subsidies	D.3	44.0	0.5	0.6	0.2	0.2	0.2
20. Gross fixed capital formation	P.51	205.4	2.3	3.0	3.7	4.3	5.1
21. Other		1345.1	15.1	13.1	13.4	12.7	12.8
22.=7. Total expenditure	TE	3221.2	36.0	37.9	39.5	39.5	39.4
Compensation of employees	D.1	904.6	10.1	9.5	9.2	8.9	8.7

* excluding FISIM
** including D.91
*** including tax collections transferred to the EU budget

3.2. Medium-Term Objective and Budgetary Implications of Structural Reforms

The Member States had to set their own medium-term objectives for the general government budget position based on pre-defined basic principles. Based on the Council's decision[1], medium-term objectives of the Member States are defined in cyclically adjusted terms and they must provide:

- a sufficient safety margin with respect to the 3% of GDP deficit limit;
- quick progress towards sustainability, taking into account the impact of population ageing on the government budget;
- taking into account the above-mentioned principles, they should allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.

The Council has set additional restrictions in setting the medium-term objectives for the euro area and the ERM II Member States, considering the need for a more open and restrictive fiscal policy, in order to promote the long-term stability of the single currency: the medium-term deficit target for low debt / high potential growth Member States may not exceed 1% of GDP, whereas for high debt / low potential growth Member States it has to be close to balance or with a surplus.

Member States whose actual budgetary position have not yet reached their medium-term objectives have to take steps to achieve it over the cycle, net of one-off and temporary measures. For the euro area and ERM II Member States annual adjustment must be 0.5% of GDP as a benchmark. Their adjustment effort must be higher in good times; it could be more limited in bad times. When defining the adjustment path, structural reforms and public investment with a verifiable and obvious positive effect on the future budgetary balance may be taken into account.

[1] Council report „Improving implementation of the Stability and Growth Pact"

Taking into account the updated Stability and Growth Pact, methodology guidelines approved by the Economic and Finance Committee, commitments following from participation in the ERM II and the national policy aimed at ensuring the macroeconomic stability, Latvia's Convergence programme defines the medium-term objective for the cyclically adjusted balance of the general government budget as -1% of the GDP.

Such amount of deficit is considerably lower than the 3% of GDP threshold prescribed by the Maastricht criteria as well as more than a half better than the minimal benchmark for the budgetary balance, which for Latvia, based on the historical economic and budgetary development, has been estimated as -2.0% of GDP. Thus, the defined Latvia's medium-term objective, providing sufficient safety margin with respect to the 3% deficit limit over the cycle, at the same time provides an opportunity to implement more active budgetary policy, promoting convergence of Latvia's level of development with the EU average.

The costs of structural reforms and increasing public investment result in Latvia's central government budget expenditure rising. Nevertheless, this expenditure is essential for ensuring the medium-term and long-term sustainability of Latvia's central government budget and raising the economic potential.

Pension and healthcare reforms have to be mentioned as the most significant reforms with a clearly measurable impact on the government budget in the medium-term and long-term.

The pension reform is expected to have a more notable impact on the government budget balance in the medium-term, as up to 2010 the share of the state social security contribution transmitted into the state funded pension scheme will gradually grow (from 2% in 2006 to 10% in 2010). Accordingly, this amount of collected social security contributions will not be included in estimates of the general government budget balance. It is expected that in 2006 the contributions to the state funded pension scheme will be 0.4% of the GDP. In 2007, they will increase to 0.7% of GDP, whereas in 2008 to 1.5% of GDP and in 2009 to 1.7% of GDP. Such a drop in revenue will be partly offset by pension expenditure within the programming period growing at a slower rate than the GDP as a result of the ongoing raising of the retirement age, due to the pension indexation formula and a lower number of population within the pre-retirement cohorts. Moreover, in the long-term the implemented pension reform will ensure the sustainability of the pension system, regardless of a significant increase in the number of pensioners and growing demographic burden, as part of the required pensions will be paid out through the funded pensions scheme.

Of other most important reforms, the healthcare reform has the most transparent relationship between the rising expenditure of today and sustainability of the future financing. Its task is to improve the quality of services and create a sustainable financing model for the sector. Improvement of the quality and accessibility of services is important if we want to improve the general health condition of the population. It increases the chances of living a larger part of one's life in good health and diminishes the possibility of disability.

At the end of 2004, the Cabinet of Ministers approved "Programme for Development of In-Patient and Out-Patient Healthcare Service Providers 2005–2010" and a detailed implementation plan was approved in 2005. In accordance with this programme, the number and dislocation of in-patient, out-patient and emergency medical service providers is being optimised, thus making the services closer and ensuring equally high quality healthcare services to the population throughout the territory of Latvia. Within the framework of the above programme, it is planned to reduce the current number of hospitals from 112 to 46 by merging, transforming or closing the existing hospitals (in 2005 and 2006, 14 hospitals have already been reorganised into 6 hospital associations). At the same time, creation of 20 new primary care doctor's (general practitioners) practices is planned as well as transformation and improvement of 50 primary care doctor's (general practitioners) practices, thus providing medical assistance as close as possible to the population. In order to establish a high-quality emergency medical assistance (EMA) system in Latvia that would be accessible to the population and cost-effective, it is planned to introduce a uniform system, structured and functioning based on universal principles for EMA teams and operative management, and a national patient or victim hospitalisation management system, so that the patient or victim is delivered to the best suited hospital in due time. These measures will ensure that the share of in-patient services, which are the most expensive medical services, in total health financing will decrease, the average treatment period will decrease by 10% and the average occupancy of beds will increase to 85%. This will also improve the opportunities to implement the latest medical technologies.

Another important component of the healthcare reform is introduction of a medicines purchase compensation system. Funding from the government budget to ensure availability of medicines for out-patient treatment has been increased, reference price principle in the system of medicines compensation has been introduced, enabling a more efficient use of the budgetary funds granted to the compensation system, improving the access to compensation medicines for the population. This ensures that patients with serious and chronic diseases get timely medicinal therapy, thus preventing deterioration of the health condition and reducing the cases of hospitalisation.

Human resources play a significant role in implementing the programme and ensuring the quality of services. In November 2006, the Cabinet of Ministers approved a programme "Human Resources Development in Healthcare 2006–2015", addressing the issues of human resource planning, education and pay in the health sector.

These and other healthcare reform measures, although ensuring more efficient spending of the existing resources and, therefore, partly covering also the costs of reforms, still require an increase of the government financing. The amount of healthcare financing increase planned for 2007 is almost 120 million lats or 0.9% of GDP, and additional provisions for implementation of the reform's tasks will have to be made in 2008 and 2009 budgets as well. Successful reform implementation will ensure the adequacy of the healthcare in light of the ongoing population ageing process and, consequently, also the expected changes in the demand for health services, as well as a higher quality of the healthcare services.

Another essential objective of the state reforms is raising the economic development potential. Here an important role alongside with ensuring adequate legislation and favourable business environment is played also by public investment. It is planned to increase the government spending on gross fixed capital formation by 2.1% of GDP by 2009 in comparison with 2006.

The above-listed reform expenditure provides for a gradual rather than immediate convergence of the general government budget balance with the set medium-term objective. The expected future gains from the implemented reforms outweigh the costs and justify the selected deficit reduction plan. Moreover, a significant increase of funding is planned also in other reform areas, where to reflect and estimate the temporary expenditure and long-term gains is not that simple.

3.3. Structural Balance

Member States have to ensure a fiscal policy in line with the cyclical development of the economy. The actual budget deficit is affected by various cyclical economic development factors that may yield higher tax collections under favourable economic development circumstances, yet under worse circumstances may result in a more rapid decline in budget revenue and increase of expenditure. A fiscal policy which is symmetrical to the cyclical economic development secures tighter budgetary discipline during the periods of buoyant economic growth, while being accommodative in periods of lower growth.

The cyclically adjusted budget balance shows what the budget balance would be if the economy was performing at its potential level. Depending on the cyclical position of the economy, the cyclical component in the actual budget deficit is identified.

In additional to the cyclical factors, the estimate of the structural budget balance identifies one-off and temporary budgetary measures having a significant effect on the budget balance of a particular period, but no effect in the medium term.

According to the Ministry of Finance estimate, using the production function method, Latvia's positive output gap has been growing since 2005. Under the circumstance of a high domestic demand, the actual GDP growth has outpaced that of the potential GDP growth in 2006 as well. Yet there are several factors underpinning also an increase in the potential output. The growing number of employed and real investment also supports the potential GDP growth. According to the macroeconomic development scenario discussed in the Convergence programme, high economic development will be supported by factors on the demand side in 2007; therefore, the positive output gap will persist at the level of 1.8%. Medium-term macroeconomic development scenario provides for a decrease of the output gap.

Latvia's potential GDP growth is primarily driven by capital and productivity growth. In 2005–2006, the number of employed increased significantly, yet in the medium term deceleration of the growth of the number of employed can be expected under the impact of demographic factors and due to reaching the optimum unemployment rate. Regardless of the need to increase and renew productive capital stock, the capital growth forecast based on the production function method is close to sustainable growth opportunities. In the medium term and in the long term, the economic growth will be primarily based on productivity growth. Taking into account the above-mentioned factors, a gradual deceleration of the potential GDP growth can be expected.

The estimate of the cyclical development of the Latvian economy and the sensitivity of the general government budget to cyclical economic development estimated by the European Commission show that the estimated cyclically adjusted budget deficit within the period addressed in the programme exceeds the planned budget deficit. In 2007–2008, the cyclically adjusted budget deficit will exceed Latvia's medium-term target of -1% of GDP. Yet the fiscal consolidation in 2008 and 2009 provides for achievement of the medium term target in 2009.

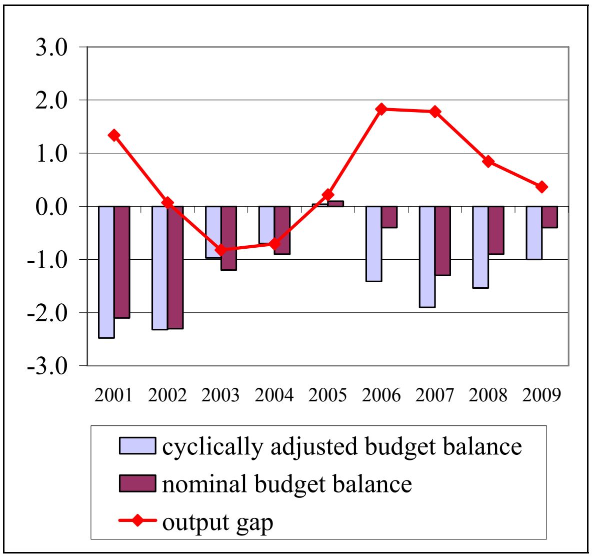

Chart 9. Cyclically adjusted budget balance (% of GDP)

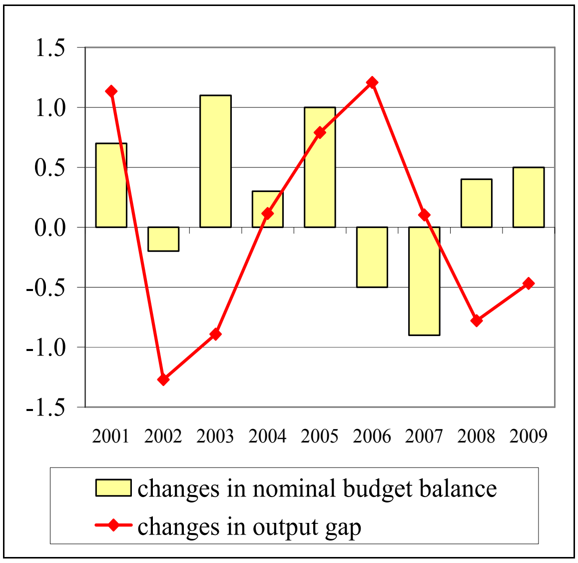

Chart 10. Changes in the fiscal position, (% of GDP)

In the previous years, the fiscal policy has been both counter-cyclical and pro-cyclical with regard to the economic development. The fiscal consolidation of 2004 and 2005 coincided with an improvement in the cyclical position of the economy (Chart 10). Yet in 2006, regardless of a high economic growth exceeding the estimated potential level, deterioration of the fiscal position can be expected. From the point of view of the macroeconomic scenario, the medium-term fiscal consolidation has been planned to happen in a period when the positive output gap will be shrinking. Nevertheless, taking into account the uncertainties relating to the estimate of the potential output, fiscal measures are required, in order to achieve the medium-term target within the period addressed by the programme.

Table 6. Cyclic development

% of GDP	ESA code	**2005**	**2006**	**2007**	**2008**	**2009**
1. Real GDP growth (%)	B1g	10.2	11.5	9.0	7.5	7.5
2. Net lending of general government	B9	0.1	-0.4	-1.3	-0.9	-0.4
3. Interest expenditure	D41	0.6	0.5	0.5	0.5	0.5
4. Potential GDP growth (%)		9.2	9.7	9.0	8.5	8.0
contribution:						
- employment		1.3	1.6	0.9	0.4	0.2
- capital		3.9	4.2	4.4	4.4	4.2
- overall production factor productivity		3.8	3.7	3.5	3.4	3.4
5. Output gap		0.2	1.8	1.8	0.8	0.4
6. Cyclic budgetary component		0.1	0.5	0.5	0.2	0.1
7. Cyclically adjusted balance (2-6)		0.0	-0.9	-1.8	-1.1	-0.5
8. Cyclically adjusted primary balance (7-3)		0.6	-0.4	-1.3	-0.6	0.0

3.4. Government Debt

The objective of the central government debt management is to ensure the financing required for the purpose of financing the government budget deficit and refinancing of the central government's debt commitments at the lowest possible costs and advantageous terms by hedging the financial risks and taking into account the development of the Latvian state capital market and all financial system. In 2005, the general government debt amounted to 1 084.6 million lats or 12.1% of the gross domestic product (hereinafter – GDP). The general government debt is primarily affected by the central government debt, amounting to 967.7 million lats and 89.2% of the general government debt in 2005.

The medium-term objectives, basic principles and tasks of the central government debt portfolio and borrowing management within the framework of the debt management are established by the Latvian national debt management strategy (hereinafter – Strategy) approved by the Minister of Finance. Types of the financial instruments that may be used in the central government debt management and drawing of the funds required for financing and selection of terms and conditions is prescribed by the guidelines approved within the Strategy, providing for compliance with optimum parameters of the structure of the central government debt portfolio as regards the currency composition of the debt, maturity profile, average interest rate duration of the debt and the optimum share of the fixed interest rates in the debt portfolio.

The measures planned for ensuring the required funding for the government deficit and central government debt commitments within the current year and the selection of the most appropriate financial instruments is prescribed by the annual Borrowing Plan approved by the Minister of Finance, which is developed for a three-year period based on the guidelines established in the Strategy and is agreed with the Bank of Latvia. Within the time period of up to 2009, the required borrowing for the government deficit and refinancing the central government debt commitments will be made both on the domestic as well as external financial market. Although the fiscal criteria established in the Maastricht Treaty are complied with and the fiscal policy implemented in Latvia is aimed at gradual reduction of the government deficit, ensuring the formulation of a balanced budget in the medium term, the limits of new borrowing depend also on the maturity profile of the existing debt commitments and their repayments in the next years.

Latvia's central government debt management has been historically aimed at development of the government securities market ensuring favourable terms and conditions for borrowing at relatively low costs. Regardless of the fact that with the foreign exchange risk on euro borrowings diminishing considerably following the lats repegging to the euro at the beginning of 2005 the lats and the euro interest rates have converged considerably (especially on a longer-term securities) reducing the borrowing costs, in 2006 the trend reversed. Therefore, in order to ensure the compliance of the central government debt portfolio composition with the targets set in the Strategy, the financing strategy of the next years could possibly be aimed at refraining from increasing the amount of outstanding domestic government securities, at the same time taking into account the developments on Latvia's government securities market. Out of the domestic government securities, medium- and long-term government bonds (3, 5 and 10–11 years) could be used for financing from 2007 to 2009 and could be offered within the framework of issue programmes, as well as Treasury bills (6- and 12-month maturity). With the planned euro implementation in Latvia approaching, it is possible that smaller, less liquid bond issues will be consolidated into larger, more liquid security issues, thus activating the secondary circulation of the government securities. In addition to the above-mentioned financial instruments, in case of a need, to ensure short-term financial liquidity short-term loans and credit facilities offered by domestic financial institutions will be used, as well as introduction of additional short-term financial instruments is possible. Their amounts and issue calendar will be decided depending on the cash flows forecast in the relevant central government budget execution period.

Drawing from foreign financial markets is anticipated: borrowing from international financial institutions, private or public offer security issues and credit facilities and short-term loans from foreign commercial banks. Eurobond issue is the most effective instrument to attract large amounts of funding by way of increasing the existing issue amounts or issuing new, liquid securities; therefore, the possibilities to use the Eurobond instrument in the period of time up to 2008 are being assessed. Nevertheless, the time of borrowing, amounts and maturities will depend on the actual central government budget execution figures, domestic and international financial market developments, central government debt portfolio indicators and other influencing factors. One of the most significant factors when taking a decision on issuing Eurobonds would be the potential amount of issue, as increasing the total amount of a new or tag-on issue to at least 500 million euro would increase the liquidity of the securities and ensure an opportunity to launch this instrument on international securities trading platforms. In accordance with the concluded agreements, use of the borrowing from international financial institutions to finance central and local government projects will continue, and it is also expected that the borrowing possibilities offered by the European Investment Bank for the purpose of ensuring the national co-financing to projects financed from the European Union's structural funds and Cohesion Fund will also be used.

In the last years, Latvia's government deficit has been low, and the fiscal policy implemented in Latvia has been aimed at gradual reduction of the government deficit, ensuring the formulation of a balanced budget in the medium term. Therefore, it can be expected that in the medium term the general government debt will remain well below the debt criterion of 60% of GDP set in the Maastricht Treaty.

Table 7. General government debt developments

% of GDP	ESA code	**2005**	**2006**	**2007**	**2008**	**2009**
1. Gross debt		12.1	10.7	10.5	10.6	9.4
2. Change in gross debt ratio		-2.4	-1.4	-0.2	0.1	-1.2
Contribution to changes in gross debt						
3. Primary balance		-0.7	-0.2	0.8	0.4	-0.1
4. Interest expenditure	D41	0.6	0.5	0.5	0.5	0.5
5. Stock-flow adjustment,		0.2	0.4	0.1	0.5	-0.4
of which: - Differences between cash and accruals		0.6				
- Net accruals of financial assets		-0.5				
of which: privatisation revenue		-0.1				
- Valuation effects and other		0.1				
p.m. Implicit interest rate on debt		4.7	5.5	5.7	5.7	5.4
Other variables						
6. Liquid financial assets		1.9				
7. Net financial debt (7=1-6)		10.2				

4. Sensitivity analysis and comparison with the previous programme

4.1. Sensitivity analysis

The central macroeconomic scenario discussed in Section 2 of the programme reflects the most likely macroeconomic development outcome. Yet the actual development may be affected by several factors that can have both a positive and a negative effect. In the last years, economic indicators pointing to imbalanced economic growth have been on a rise.

Domestic sources of growth have a large role at the current stage of economic development; nevertheless, the terms of the external economic environment also have a significant impact on the domestic factors. Latvia's high economic growth is underpinned by increasing consumption and investment, which is supported by favourable monetary conditions, development of consumer behaviour and economic policy measures. Domestic demand may be significantly affected by both external factors (like the euro interest rate developments, changes in investor sentiments, failures on export markets) and internal factors (changes in consumer confidence, adverse developments on the real estate market, inflationary pressure on competitiveness).

Considering the above-mentioned risks, there is a high degree of uncertainty as regards the economic development trends. Within the framework of the sensitivity analysis, it is assumed that the overall medium-term GDP growth will differ from the central scenario by 1 percentage point, and these differences will be primarily based on a higher or lower private consumption growth. Increase or decrease of the private consumption by 1.3 percentage points would lead to changes in GDP amounting to 1 percentage point. Acceleration or deceleration of the economic activity relates to a higher or lower growth of external trade, i.e. export and import growth. Taking into account the high intensity of imported goods in Latvia's exports, the export growth causes a respective import growth. The higher growth scenario provides for a more rapid improvement of the external trade, whereas the lower growth scenario for a slower reduction of the trade deficit in comparison with the central scenario accordingly. Such an outcome is based on the assumption that in the medium-term domestic demand will be less dependant on imports.

Various development scenarios point to insignificant impact on employment and unemployment, whereas the changes in productivity growth are more considerable. Productivity growth relates closely to the increase of wages and salaries, which affects the purchasing power of the population and revenue from employment taxes.

According to the assumptions of the higher economic growth scenario, income tax revenue (D.5) could grow by about 7.8 million lats. Actual social security contributions (D.611), in turn, could increase by 12.0 million lats. It has to be noted that the growth rates of those taxes are comparatively high already; therefore, no especially sharp increase is anticipated. In 2007, the growth of the income tax revenue will also be dampened by the notable increase of the non-taxable minimum and relief for dependants which are exempt from the personal income tax.

According to the assumptions of the lower economic growth scenario, comparing with the central scenario, there is an opposite effect to that of the optimistic scenario. Income tax revenue (D.5) could decrease by about 8.5 million lats, whereas actual social security contributions (D.611) could shrink by 13.1 million lats.

Deceleration of imports could adversely affect the growth rates of the value added tax revenue (D.211). Alongside with slower growth rates for wages and salaries, domestic demand, which also is to be considered one of the most important macroeconomic indicators driving the value added tax revenue, will weaken as well.

Sensitivity analysis scenarios have been developed, assuming that the price indices remain unchanged as compared to the central scenario. The volume of public consumption in all scenarios has been preserved unchanged as well.

Table 8. Macro-economic indicators of the central scenario

		2007	2008	2009
Real GDP	growth (%)	9.0	7.5	7.5
Number of persons employed in the economy	growth (%)	1.5	1.0	0.5
Unemployment rate	%	6.6	6.4	6.2
Average wage and salary in the country	growth (%)	17.6	12.0	11.5
Current account	% of GDP	-18.6	-17.7	-17.2

Table 9. Macro-economic indicators of the higher growth scenario

		2006	2007	2008
Real GDP	growth (%)	10.0	8.5	8.5
Number of persons employed in the economy	growth (%)	1.7	0.9	0.5
Unemployment rate	%	6.5	6.3	6.1
Average wage and salary in the country	growth (%)	18.8	13.0	12.5
Current account	% of GDP	-18.4	-17.3	-16.7

Table 10. Macro-economic indicators of the lower growth scenario

		2006	2007	2008
Real GDP	growth (%)	8.0	6.5	6.5
Number of persons employed in the economy	growth (%)	1.3	1.1	0.5
Unemployment rate	%	6.7	6.5	6.3
Average wage and salary in the country	growth (%)	16.4	10.9	10.4
Current account	% of GDP	-18.8	-18.1	-17.8

4.2. Comparison with the 2005 Convergence Programme

Table 12. Comparison with 2005 Convergence Programme forecasts

	ESA code	**2005**	**2006**	**2007**	**2008**	**2009**
Real GDP growth (%)	B1g					
2005		8.4	7.5	7.0	7.0	-
2006		10.2	11.5	9.0	7.5	7.5
Difference		1.8	4.0	2.0	0.5	-
General government net lending (% of GDP)	B.9					
2005		-1.5	-1.5	-1.4	-1.3	-
2006		0.1	-0.4	-1.3	-0.9	-0.4
Difference		1.6	1.1	0.1	0.4	-
General government gross debt (% of GDP)						
2005		13.1	14.9	13.6	13.7	-
2006		12.1	10.7	10.5	10.6	9.4
Difference		-1.0	-4.2	-3.1	-3.1	-

At the end of 2005 and in 2006, the GDP growth was very buoyant and exceeded the initial forecasts, resulting in an upward revision of the forecasts. High economic activity will prevail in 2007 as well, due to the perseverance of several growth-promoting factors which existed in the last two years and basically underlay the growth of the domestic demand. GDP growth is expected to moderate in the medium term, at 7%–7.5%.

In 2005, the actual general government budget execution results were better than initially forecast and there was a surplus in the amount of 0.1% of the GDP. All budgets performed better than planned, yet the surplus of the general government budget resulted from a considerable surplus in the social security budget amounting to 1.3% of GDP and a small surplus in the local government budget. These tendencies are expected to prevail in the next years as well, and according to the forecasts the general government budget deficits will be lower than the those planned in the 2005 Convergence Programme.

General government debt forecasts are lower in 2006, because in the last years the government deficit in Latvia has been lower than planned and due higher GDP base effect as well. Latvia’s fiscal policy is aimed at gradual reduction of the general government deficit, ensuring the formulation of a balanced budget in the medium term. Based on that, it is estimated that the general government deficit will decrease to 9.4% of GDP in 2009.

5. Quality of Public Finances

5.1. Revenue of the General Government Budget

Latvia's tax policy is aimed at ensuring stable and predictable tax revenue, in order to implement the government's social and economic priority measures and limit the deficit. The key focus of the tax policy previously implemented in Latvia was establishment of a system that would facilitate economic growth, ensure competitiveness and attraction of investment as well as would prevent the conditions distorting competition. One of the main areas of the implemented tax policy was gradual decrease of the corporate income tax rate. As a result of the implemented policy, Latvia's corporate income tax rate currently stands at 15%, being one of the lowest rates in the European Union.

The overall tax burden in Latvia is one of the lowest in the EU, with only the one in Lithuania being lower. In 2005, it amounted to 29.4% of GDP, which is considerably lower than the EU average at 39.9% of GDP.

Personal Income Tax

Estimates show that the tax burden on the income of population remains very high. In 2005, employment taxes accounted for 49.0% of the total tax revenue.

The minimum threshold of income exempt from the personal income tax remained unchanged from 1997 to 2004. As a result, the tax burden actually increased, especially on lower-income population. In 2005, the non-taxable minimum was increased from 21 to 26 lats per month, whereas relief for dependants from 10.50 to 18 per month. In 2006, the non-taxable minimum for the personal income tax purposes and relief for dependants was raised further to stand at 32 and 22 lats per month respectively. In order to increase the income of population and thus facilitate higher purchasing power and solvency level of population, particularly low-income population, the non-taxable minimum for the personal income tax purposes and relief for dependants are raised again from 32 to 50 lats per month and from 22 to 35 lats per month respectively starting from 2007.

A gradual raise of the non-taxable minimum exempt from the personal income tax and relief for dependants is a tax policy measure mentioned in Latvia's national Lisbon Programme 2005–2008. It is forecast that the implementation of this measure will improve the motivation of the employed and the financial attractiveness of employment.

In order to facilitate improvement of the welfare of population as well as to partly compensate the decline in the actual revenue caused by inflation growth, in addition to raising the personal income tax allowances, the minimum monthly wage and salary is gradually increased. In 2007, the minimum wage and salary will be raised from 90 lats to 120 lats per month.

Table 12. Raise of the non-taxable minimum and relief for dependents and of the minimum monthly wage and salary (in lats)

	2004	2005	2006	2007
Minimum monthly wage and salary, lats	80	80	90	120
Monthly non-taxable minimum, lats	21	26	32	50
Monthly tax relief for a dependent, lats	10.5	18	22	35
Impact of changes in non-taxable minimum and relief for dependants, millions of lats				-63.5
Impact of changes in the minimum wage and salary, millions of lats				+18.5
Total impact of changes, millions of lats				-45.1
Total impact of changes, % of GDP				-0.4

Considering that one of the most important priorities of the government is improvement of the living standards of the community, further increase of wages and salaries is experienced in several sectors of the economy and social programmes in 2007. Teachers' wages and salaries continue to climb in 2007. Wages and salaries will be raised for those employed in the system of interior affairs, medical personnel, those employed in the sector of culture, judges and court employees. In order to better motivate those employed in public administration, reduce staff turnover and attract qualified personnel, additional funding is envisaged for raising the institutional capacity of the public administration. Higher wages and salaries for those employed in the public sector will promote an increase of both personal income tax collections and social security contributions.

Social Security Contributions

According to the ESA 95 requirements, social security contributions channelled to the state funded pension scheme are not treated as the budgetary revenue of the general government.

In accordance with the law "On State Funded Pensions", up to 1 January 2007 the rate of contribution into the state funded pension scheme is 2%. Starting from 1 January 2007, the rate of contribution will be gradually raised resulting in significantly higher revenue from social security contribution received in the funded pension scheme, which will compress the social security budget revenue accordingly. In line with the provisions of the Law, the rate of contributions will be raised from 2% in 2006 to 9% in 2009. The most notable increase in the rate of contribution to the state funded pension scheme is expected in 2008, when the rate will grow by 4 percentage points, i.e. from 4% to 8%.

Table 13. Social security contributions to the state funded pension scheme

Year	Rate of contribution	Social security contributions transferred to the funded pension scheme, in millions of lats	Social security contributions transferred to the funded pension scheme, % of GDP
From January 1, 2005	2%	29.6	0.3
From January 1, 2006	2%	41.3	0.4
From January 1, 2007	4%	94.6	0.7
From January 1, 2008	8%	219.6	1.5
From January 1, 2009	9%	282.9	1.7

Corporate Income Tax

With a view to ensuring the basic freedom provided in the Treaty establishing the European Community, amendments to the law "On Corporate Income Tax" have been introduced, in effect from 2007. These amendments provide for the same tax treatment for dividends received from residents of the European Union (EU) and European Economic Area (EEA) as for domestic dividends, i.e. in a general case the dividends received from the EU and EEA are also excluded from the taxable income of a taxpayer.

As a result of this provision, a decrease of corporate income tax revenue is expected in 2007, which could amount to 6.5 million lats.

Excise Tax

In compliance with the transition period granted to Latvia, excise tax on cigarettes has to be gradually raised until 1 January 2010, thus ensuring alignment of the excise tax rates on tobacco products with the minimum EU rate. In 2006, Latvia's government resolved to speed up raising of the excise tax rate on cigarettes. This way, the minimum rate set in the EU will be reached already in 2009, taking into consideration also the developments of the exchange rate of the lats vis-à-vis the euro since 2002, when the estimates for the previous excise tax raise were made.

Chart 14. Excise tax rates on cigarettes (for 1000 cigarettes)

Period	Rates (effective until 30.06.2007)	Rates (effective from 01.07.2007)
from 01.07.2003 to 31.12.2003	LVL 5.8 + 1.8% of MRP*	LVL 5.8 + 1.8% of MRP
from 01.01.2004 to 31.12.2004	LVL 6.3 + 6.1% of MRP	LVL 6.3 + 6.1% of MRP
from 01.01.2005 to 31.12.2005	LVL 6.9 + 10.5% of MRP	LVL 6.9 + 10.5% of MRP
from 01.01.2006 to 31.12.2006	LVL 7.6 + 14.8% of MRP	LVL 7.6 + 14.8% of MRP
from 01.01.2007 to 30.06.2007	LVL 8.4 + 19.2% of MRP	LVL 8.4 + 19.2% of MRP
from 01.07.2007 to 31.12.2007	LVL 8.4 + 19.2% of MRP	LVL 10.0 + 25.0% of MRP
from 01.01.2008 to 31.12.2008	LVL 9.3 + 23.5% of MRP	LVL 17.8 + 32.2% of MRP
from 01.01.2009 to 31.12.2009	LVL 10.5 + 27.9% of MRP	LVL 22.5 + 34.5% of MRP
from 01.01.2010 to 31.12.2010	LVL 17.8 + 32.2% of MRP	LVL 22.5 + 34.5% of MRP

** MRP – maximum retail price*

From 1 January 2007, excise tax on smoking tobacco, i.e. fine cut tobacco for rolling of cigarettes also increase.

Increase of the excise tax on tobacco products will secure higher excise tax revenue in 2007 as well as in the medium term. In 2007, raise of the excise tax on tobacco products will increase the excise tax revenue by 16.8 million lats.

Considering that Latvia has been granted a transition period for application of the minimum excise tax rate on oil products and the provision that the rates set in the national currency have to be adjusted in light to the euro and lats exchange rate fluctuations, excise tax rates on oil products are raised from 1 January 2007. Higher rates will result in the excise tax revenue from oil products growing by 20.4 million lats in 2007.

Value added tax

According to the amendments to the law “On Value Added Tax” adopted by the Parliament on 8 June 2006, a reduced value added tax rate of 5% is applied instead of the previously applied 18% from 1 January 2007 to:

- electricity supplies for non-commercial purposes;
- natural gas supplies for non-commercial purposes;
- hairdresser services to final consumers (natural persons);
- simplified renovation services of inner premises of residential block houses (apartments) supplied for non-commercial purposes.

These amendments are expected to have a negative effect on the budget, as application of a 5% rate will result in tax payments into the budget in the amount of 5%, while the input tax will be deducted in full amount. The impact of the previously mentioned changes will reduce the value added tax by 10.2 million lats in 2007.

Table 15. Fiscal impact of main tax policy changes (% of GDP)

	2007	**2008**	**2009**
Personal income tax revenue (raising the non-taxable minimum , relief for dependents and minimum wage and salary)	-0.4	-	-
Social security contributions revenue (raising the rate of contributions payable into the funded pension scheme)	-0.7	-1.5	-1.7
Corporate income tax revenue (exemption from tax for dividends from the EU and EEA)	-0.1	-	-
Excise duty revenue (raising the rate on oil products and tobacco products)	+0.3	+0.2	+0.3
Value added tax revenue (reduces rate on supplies of electricity, natural gas etc. for non-commercial purposes)	-0.1	-	-
Total impact of tax policy changes:	**-0.9**	**-1.3**	**-1.5**

Based on the medium-term economic development trends and expected changes in legislation, it is forecast that overall the growth rates of tax revenue in the general government budget will exceed the GDP growth rates at current prices as forecast, and the ratio of tax to GDP will go up from 29.1% in 2005 to 29.8% in 2009.

Table 16. Tax revenue in general government budget (S.13) (millions of lats)

	Code (ESA 95)	**2005**	**2006**	**2007**	**2008**	**2009**
Tax revenue						
1. Production and imports taxes	D.2	1126.0	1405.0	1718.6	2001.0	2265.1
2. Current income and property taxes	D.5	714.9	941.0	1097.9	1260.6	1422.7
3. Social contributions	D.61	777.9	965.7	1074.4	1122.9	1229.1
Of which actual social contributions	D.611	*760.3*	*947.2*	*1055.4*	*1103.6*	*1209.6*

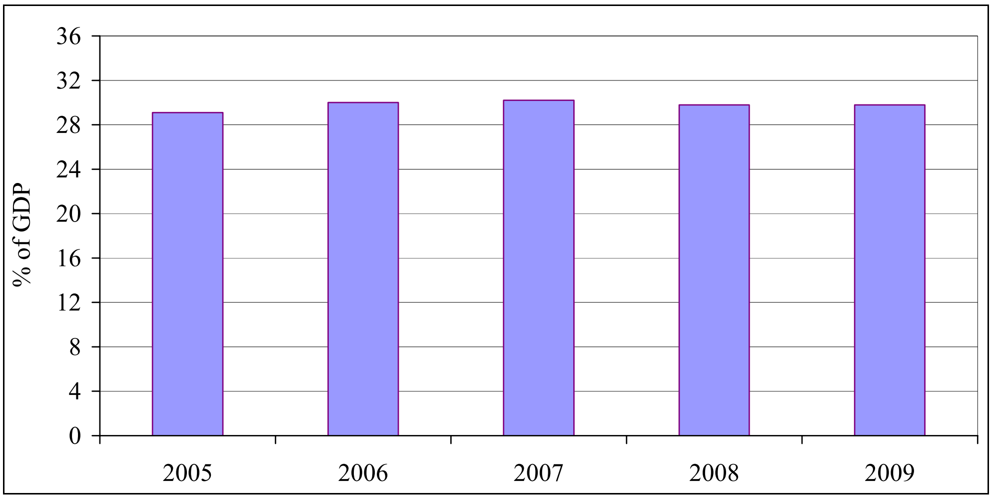

Chart 11. Tax revenue (% of GDP)

Analysis of the tax revenue by economic function reveals that in the period from 1995 to 2004 the major share of revenue in Latvia (50.9%) was comprised of labour taxes, which was roughly consistent with the overall situation in the EU, where the average figure was 51.0%. Consumption taxes amounted to 37.1% of the total tax revenue, which was considerably above the EU average (27.9%), but consistent with the taxation system of the new EU Member States (34.9% on average). A minor share of tax revenue is comprised of capital taxes (in 1995–2004, 11.9% on average), which is considerably lower than the EU average (21.3%).

No significant changes in the tax structure are expected in the medium term. Nevertheless, considering the raising of the non-taxable minimum for the personal income tax purposes and relief for dependants which started in 2005, it can be expected that the share of employment taxes in the total revenue will slightly shrink. In the medium term, the share of employment taxes in the total revenue is also compressed by increasing the rate of contribution into the state funded pension scheme from 2% in 2006 to 9% in 2009. Yet taking into account the changes concerning the excise tax rates, a small increase in the share of consumption taxes can be anticipated.

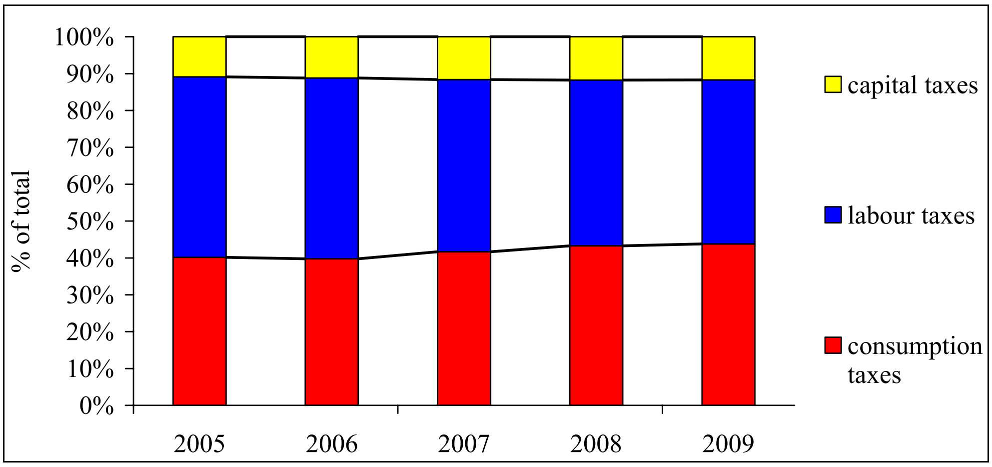

Chart 12. Tax revenue by economic function (% of total tax revenue)

5.2. Expenditure of the General Government Budget

General government expenditure has been relatively low in the previous years, below 36.0% of GDP. It is forecast that in the medium term the ratio of the general government expenditure to GDP will increase slightly, yet will not be higher than 40.0% of GDP.

It is forecast that in the medium term the currently ongoing reforms aimed at increasing the performance efficiency of the health and interior affairs systems will continue, larger spending on national security, safety and NATO participation will be ensured and co-financing for the funding granted by the European Union will be provided.

Taking into the planned movement towards gradual reduction of the budgetary deficit of the general government with a view to ensuring the formulation of a balanced budget in 2010, it is forecast that the growth rates of the general government budget expenditure will decelerate in the medium term.

Alignment and improvement of the general infrastructure is an important function of the general government. It is forecast that the general government spending on gross fixed capital formation will increase in the medium term. The central government budget spending on gross fixed capital formation will be mainly used on road projects (including improvements on the *VIA Baltica* highway and West–East corridor as well as widening of roads, reconstruction of crossroads, renovation of road surfaces) and on development of railroad infrastructure (replacement of track turnouts, construction of a new rail marshalling yard in Rēzekne), thus making a successful use of funding granted by the Cohesion Fund. Within the framework of the Cohesion Fund, it is planned to implement reconstruction of access roads to

Ventspils port terminals and Liepāja port. The largest investment from the local government budget will be channelled to environmental protection and social infrastructure projects.

It is forecast that in the medium term the spending on the **health sector** will continue to grow, in order to ensure the implementation of the guidelines "Human Resource Development in Healthcare" approved by the government on 18 May 2005, based on which the programme "Human Resource Development in Healthcare 2006–2015" was developed.

The programme provides for implementation of the following tasks:

- effective planning of human resources in the healthcare sector;
- provision of the healthcare sector with the required human resources in terms of number, dislocation and required qualifications;
- development of an education system in the healthcare sector (higher, vocational, further education) in line with the labour market demand;
- improvement of the work pay system, creation of a system of social guarantees and professional risk insurance for medical personnel.

In addition to the above-mentioned programme, a "Programme for Development of In-Patient and Out-Patient Healthcare Service Providers" has been approved and "Implementation Plan 2005–2010 for the Programme for Development of In-Patient and Out-Patient Healthcare Service Providers". The objective of the programme is to ensure further development of an integrated healthcare system by optimising the number and dislocation of service providers, thereby raising the quality of the delivered healthcare services, cost-efficiency and effective availability to patients. In order to implement the defined programme objective, the primary healthcare system will be developed and the network of the primary healthcare service providers will be improved, high quality and cost-efficient emergency medical aid system will be established, a highly specialised, high quality, mutually coordinated and cost-efficient secondary and tertiary level healthcare system will be created, the structure of the secondary and tertiary level healthcare service providers will be improved, a medical rehabilitation system with a network of regional medical rehabilitation institutions will be created as well as an efficient dislocation, good accessibility to population and efficient use of medical technologies will be secured.

In order to implement the measures set forth in the above-mentioned policy planning documents, it is planned to increase the wages and salaries of the medical personnel by 65.1 million lats in 2007 as compared to 2006 and to raise spending on ensuring the provision of healthcare services by 40.8 million lats, compensations for medications to population and medical treatment establishments by 14.0 million lats.

It is expected that the healthcare sector reforms will continue in the medium term, and it is forecast that it will result in the spending in healthcare sector growing from 4.0% of GDP in 2004 to 5.5 % of GDP in 2009[2].

An important medium-term priority of the general government budget expenditure is raising the performance efficiency of the system of interior affairs. As compared to 2006, additional provisions have been made in 2007 budget for increasing the wages and salaries of special rank officials (by 36.5 million lats). It is expected that the performance of the interior affairs system will be optimised in the medium term, with a view to improving its performance efficiency. Fire-fighting and rescue system is one of the most important areas of the interior affairs. The Cabinet of Ministers has approved a Plan for creation of a universal national fire-

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[2] According to the COFOG classification

fighting and rescue system for the period of 2005–2011. The approved plan provides for structural and functional changes in the State Fire-Fighting and Rescue Service (VUGD), in order to ensure the implementation of the function of monitoring fire safety and fire containment in forests and improve the material and technical provisions of the service. The 2007 budget provides for additional spending on ensuring the functioning of the VUGD. Taking into account the planned measures to improve the performance of the system of interior affairs, it is forecast that the ratio of spending on **public order and security** to GDP will increase in the medium term.

Provisions are made in the general government budget 2007 and beyond for implementation of the measures stipulated in Latvia's national Lisbon programme (hereinafter – Lisbon programme).

In order to stimulate scientific activity and development as envisaged by the Lisbon programme, the 2007 budget contains provisions for the development of the **science** sector, including funding of scientific activity and scientific framework in the amount of 37.3 million lats, funding for a government financed scientific research programme in the amount of 6.3 million lats.

The Lisbon programme pays significant attention to raising employment by improving the ability of the **education system** to adjust to the labour market needs. In order to ensure that, the 2007 budget provides for a 4.3 million lats increase over 2006 for spending on improvement of the quality and development of vocational education to meet the labour market needs.

In order to implement the measures envisaged in the Lisbon programme for increasing **employment**, the 2007 general government budget contains provisions for implementation of active employment measures. Active employment measures include government support to business start-ups and starting off as a self-employed person.

The Lisbon programme contains also measures aimed at **information society development**. In order to implement this measure, the 2007 budget has additional provisions in the amount of 1.2 million lats in comparison with the 2006 budget for national information system integration and e-service development.

6. Sustainability of Public Finances

Latvia's population started to shrink in 1990, with both natural movement of population (net balance of birth and death rates) as well as cross-country migration changing radically from positive to negative. The overall number of population living in Latvia at the beginning of 2006 was 2.29 million or by 374 thousand (14%) less than 16 years ago (including a decrease in population by 182 thousand as a result of natural movement). In the last years, the rate of decline in population has decelerated; nevertheless, it is expected that this tendency will prevail in Latvia in the long-term as well.

According to Eurostat forecasts[3], by 2050 Latvia's population will decrease by another 19% and amount to a mere 1.87 million. The forecasts are based on the assumption that the birth rate will increase from the current 1.3 to 1.6, which still is not enough to stabilise the number of population. The negative balance of natural movement will decrease also due to growing life expectancy of population. According to the forecast, net migration will remain negative

[3] Hereinafter the base scenario of the Eurostat demographic forecast EUROPOP2004 is discussed.

until 2020, when it will become positive, with Latvia's economy reaching a higher level of development.

Alongside with changes in the number of population, age profile of population will also change significantly. The share of young people will gradually contract, determined by the birth rate which is constantly below the natural reproduction threshold and a decrease in the number of fertility age women. In the age group of 0–14 years, in 2050 the number of population will be 16% lower than in 2006. Moreover, as opposed to other age groups, changes in the number of young people are more pronounced already now as a result of the 10 year long low birth period. Working age (15-64) population will decrease by 30% or 470 thousand by 2050, whereas the number of senior people (65+) will grow by 27% or 103 thousand, including the number of very old people (80+) will increase more than twice or by 83 thousand by 2050. This suggests that the increase in the number of senior people will be primarily the result of higher life expectancy.

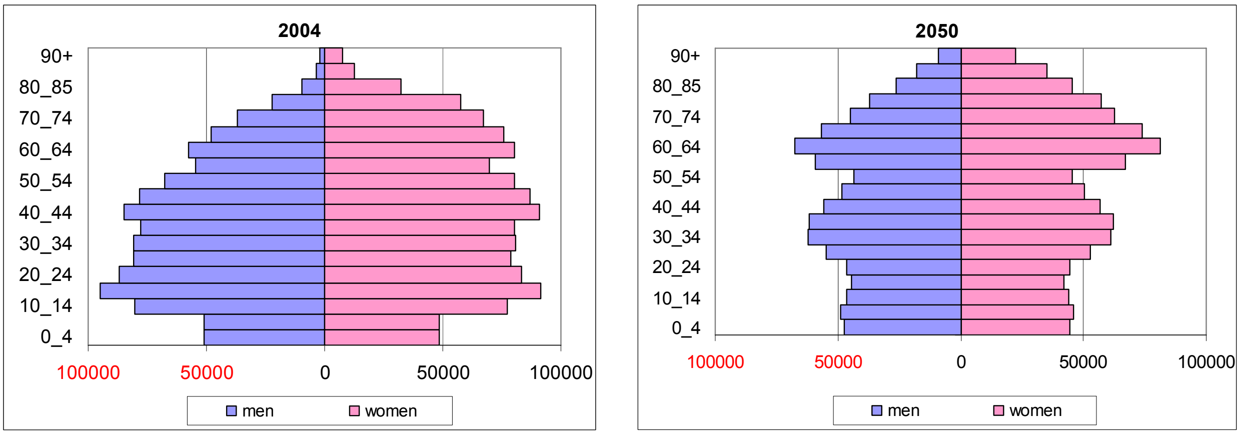

Chart 13. Changes in population by age group

Labour force and employment[4] will basically develop, based on changes in the number of working age population. Nevertheless, it will also be significantly affected by changes in participation and employment rates.

Changes in participation rate are affected by various factors, the most significant being the social (duration and quality of education, the role of women in the society etc.), demographic (birth rate, age profile), institutional (retirement age etc.) and economic (labour demand, income level etc.) ones. In the next years, gradual rising of the participation rate, especially in the older groups of employed (over 55) is forecast, and these are the only groups where a real increase in the number of employed is expected by 2050. Unemployment will decrease gradually; nevertheless, in order to keep the forecasts prudent, it is assumed that it will be at least 7%[5].

Overall, these factors determine that the number of employed in 2050 will be 20% lower in comparison with 2004. Nevertheless, contrary to the demographic indicators, it is expected that the number of employed will continue to rise gradually until 2012 and start shrinking only after that (falling back to the level of 2004 again in 2021).

[4] Latvia's employment and macroeconomic assumptions are based on the ones approved by the Ageing Working Group of the EU Economic Policy Committee.

[5] Actual current EU15 NAIRU

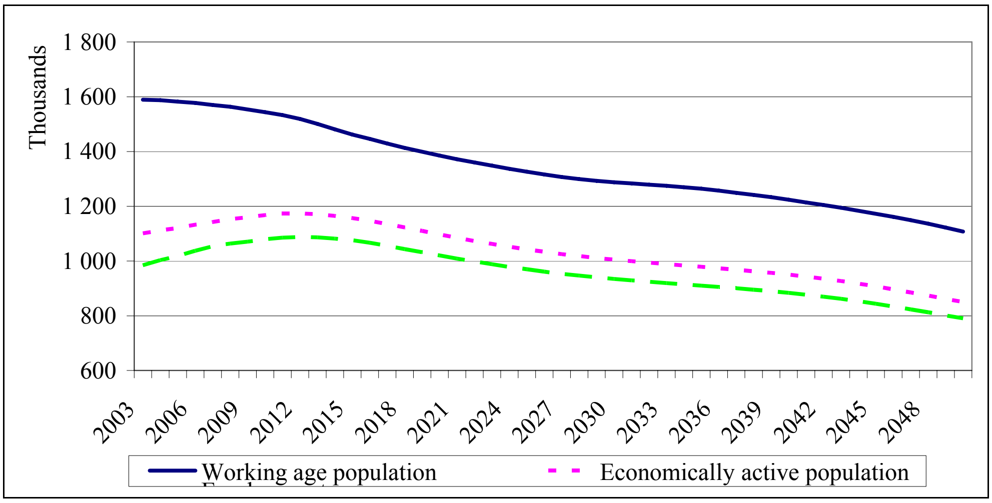

Chart 14. Working age population and employment in 2003-2050.

In the last years, Latvia's economy has achieved high growth rates driven by a rapid increase in investment and productivity. Estimates based on production function method suggest that the development will be equally dynamic and buoyant in the medium term as well, additionally facilitated by policies aimed at the cohesion of the EU Member States. Regardless of the fact that the decline of employment will start to exert an adverse impact on growth already from 2013, the average GDP growth in the period of up to 2050 is expected almost twice as high as in the EU15 countries, ensuring convergence of the living standards with the EU average. According to this scenario, in 2030 the GDP per capita in Latvia will reach 93% of the EU15 average, whereas in 2040 already 99%.

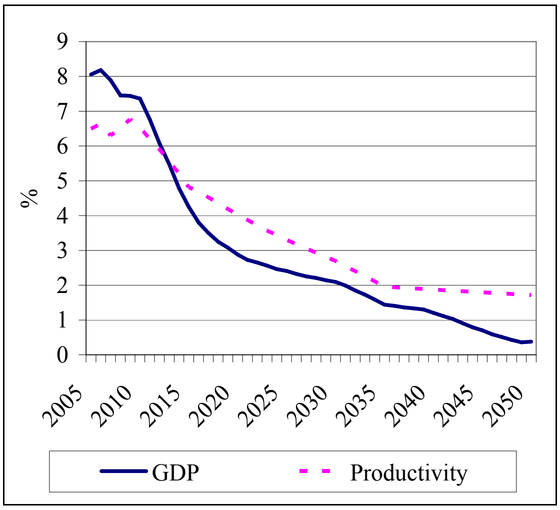

Chart 15. GDP and labour productivity growth at constant prices

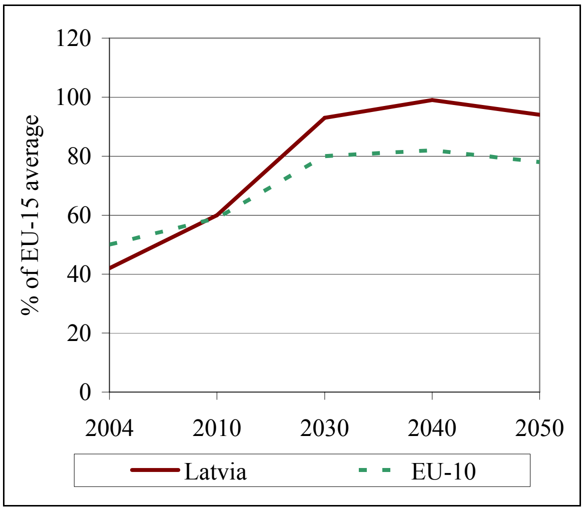

Chart 16. GDP per capita PPS % of EU15 average

Changes in the number of population and especially in the age profile will exert a significant impact on the government budget, as the working age population will shrink and social expenditure will grow.

In order to address the financial problems of the pension system that may be caused by the emerging demographical changes, Latvia launched pension reforms already in 1996 by raising the retirement age and creating the state compulsory non-funded, security contributions-based generation solidarity pension scheme and further-on implementing the state compulsory funded pension scheme (in 2001) and creating the legislative framework for the private pension scheme (in 1998). Although all these three pension tiers are already operational, various transition provisions will still be in effect for a certain period of time, affecting both the existing as well as the new pensioners.

The current and expected costs of implementing the pension system reform are fully outweighed by long-term gains, enabling the employed to cope with the growing demographical burden, at the same time preserving a sufficiently high income substitution level for pensioners as well as ensuring sustainability of the pension budget.

Pension expenditure of the central government budget estimated based on the above-mentioned demographical and macroeconomic assumptions are expected to be by 1.2% of GDP lower in 2050 than in 2004, whereas the expenditure of the funded pension scheme will rise to 2.7% of GDP. At the same time, pension contributions to the central government budget will shrink, as already starting from 2010 half of the contributions will be channelled to the funded pension scheme. Therefore, starting from 2030 it is expected that contributions to the pension budget will be lower than the amount of expenditure, although the annual level of deficit in this budget will not exceed 0.5% of GDP. It has to be noted that in the period beyond that, improvement of the situation and a decrease in the burden on the pension system relating to both gradual improvement of birth rates and a decline in death rates in the working-age group can be expected. Stabilisation of the situation in a more distant future is driven also by the pension system becoming fully functional (i.e. past the transition period). Forecasts show that all pensions will become contribution-based generation solidarity pensions only around 2080.

At the same time, accumulated assets of the state funded pension scheme will expand significantly during the next 50 years and will serve as a driving force for economic development.

The above estimates suggest that the stability of the pension system can be preserved even under less favourable demographic and macroeconomic assumptions.

Table 17. Sustainability of the pension system

% of GDP	2004	2010	2020	2030	2050
Old-age pension expenditure	6.8	4.9	5.0	6.0	8.3
Tier 1 pensions	6.8	4.9	4.9	5.6	5.6
Tier 2 pensions	0.0	0.0	0.1	0.4	2.7
State social security contributions for old-age pensions	7.3	8.4	8.3	8.4	8.5
Tier 2 pensions	7.1	6.1	5.6	5.4	5.4
Tier 2 pensions	0.2	2.3	2.7	3.0	3.1
Accumulated assets of state funded pension scheme	0.3	7.7	28.7	50.9	75.4

Analysis of healthcare expenditure suggests the largest costs are associated with senior people, especially during the last years of their lives. Therefore, the increase in the number and share of old and very old people may create an additional demand for healthcare services paid from the central government budget. In 2004, the central government expenditure on healthcare amounted to 5.1% of GDP[6]. Assuming that the current expenditure structure by age groups will remain unchanged in the future, it can be expected that the central government healthcare expenditure will grow to 6.2% of GDP by 2050. The previous experience, however, suggests that the demographic changes have not been the only reason for changes in the healthcare expenditure. Factors like public health condition, economic development, technological progress, changes in healthcare financing and organisation system etc. have been of an equal importance.

[6] According to the OECD Health accounts system methodology.

Long-term care services are primarily focussed on older people and, therefore, ageing of the population could affect the size of the given expenditure covered from the central government budget significantly. Nevertheless, although under the impact of demographic factors it could grow by more than twice by 2050, it will only amount to 0.7% of GDP as compared to the current 0.4% of GDP. The fact that the long-term care expenditure is low is pre-determined by the limited central and local government resources to be spent for this purpose as well as traditions and the system of community values. Therefore, with these factors changing, a more rapid expansion of the long-term care services and, consequently, also expenditure could still be expected in a more distant future.

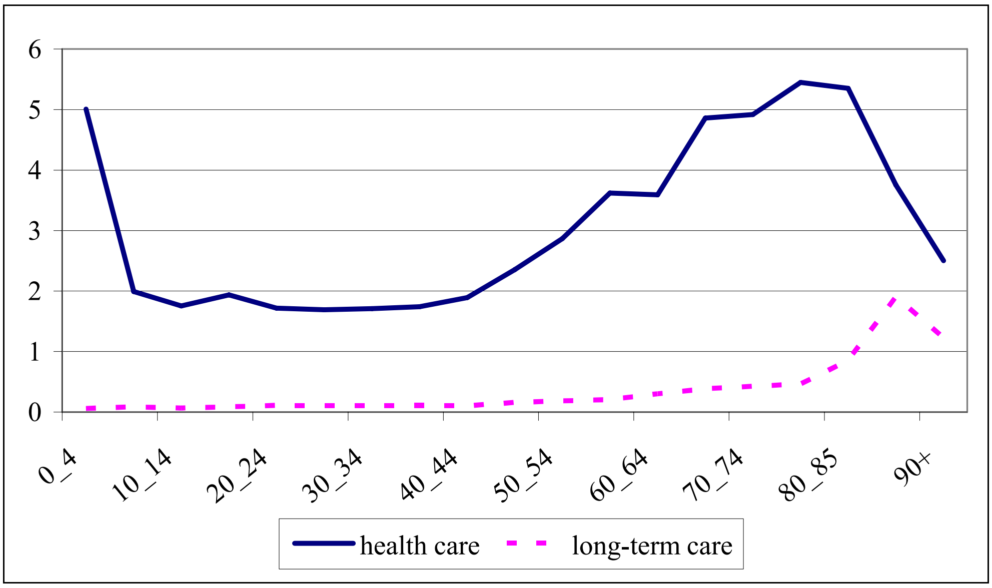

Chart 17. Healthcare and long-term care expenditure by age group (% of GDP per capita in 2003)

Education services are primarily delivered to children and youths. Demographic changes within this age group have the most significant impact on education expenditure. The number and share of children and youths in Latvia has been on a constant decline already since 1990, which has become especially rapid after 1995. The cohorts of low birth rate years have already reached the school-age, and the number of school students will continue to shrink in the next years as well. In comparison with 2000, the number of school-age population will be almost 30% lower in 2010. This suggests that the demographic factor will promote a decrease in education expenditure, provided that the relative amount of education expenditure per recipient of education services remains unchanged. Consequently, the central government expenditure for education could decrease from 4.9% of GDP[7] in 2004 to 3.0 % of GDP in 2015. Yet as the number of children is expected to stabilise at a higher level afterwards, the amount of expenditure could grow again to 3.5% of GDP. Thus, contrary to the pension and healthcare systems, the pass-through of demographic changes on the education system is much quicker, and the biggest changes are expected within the period of time up to 2015.

[7] ISCED levels 1–6, pre-school education excluded

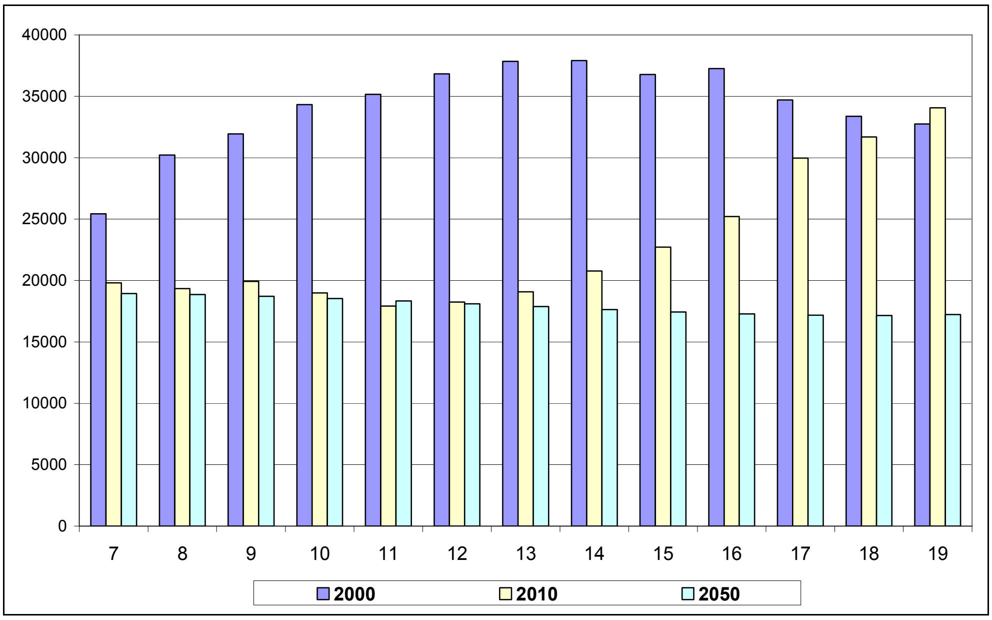

Chart 18. Number of population aged 7 –19 in 2000, 2010 and 2050

In addition to that, based on the methodology approved by the Ageing Working Group of the Economic Policy Committee, sustainability estimates take into account changes in public expenditure on unemployment benefits. Considering that the macroeconomic assumptions provide for a decline in unemployment rate in Latvia, these changes will have a positive effect on the government budget balance; nevertheless, due to the modest size, the impact will be insignificant (expenditure will decrease from 0.3% of GDP to 0.2% of GDP).

The reform of the pension system and the impact of a decline in the number of children on education expenditure are the key factors determining that, given a no-change of the current policy, population ageing tendencies will have no adverse impact on public finances. Only after 2015, public expenditure directly relating to the age profile of population will deteriorate the overall general government budget balance.

Thus, the estimates of the system of public finances based on the Eurostat's demographic forecasts and the 2006 Ageing Report of the Economic Policy Committee, do not point to significant long-term sustainability risks and confirm the positive long-term effect of the pension reform. At the same time, they also reveal that all the potential developments in public policies and financing need to be carefully considered, as the expected demographic changes are very dramatic and any policy adjustments may bear significant long-term consequences.

Table 18. Sustainability of public finances

% of GDP	**2004**	**2010**	**2020**	**2030**	**2050**
Total expenditure	36.2	39.0	38.9	40.3	40.5
Of which: age-related expenditures	17.2	13.8	13.8	15.1	15.3
Pension expenditure	6.8	4.9	4.9	5.6	5.6
Social security pension	6.8	4.9	4.9	5.6	5.6
Old-age and early pensions	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	1.1	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Healthcare	5.1	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.6	3.3	3.1	3.5	3.3
Other age-related expenditures	0.33	0.3	0.2	0.2	0.2
Interest expenditure					
Total revenue	35.3	39.0	38.6	38.4	38.5

% of GDP	2004	2010	2020	2030	2050
Of which: pension contributions	7.1	6.1	5.6	5.4	5.4
Pension reserve fund assets					
Of which: consolidated public pension fund assets (assets other than government liabilities)					
Assumptions					
Labour productivity growth	6.4	6.5	4.0	2.7	1.1
Real GDP growth	7.5	7.4	2.9	2.1	0.4
Participation rate males (20–64)	83.4	87.6	89.6	89.5	87.6
Participation rate females (20–64)	71.9	76.2	79.0	79.8	76.6
Total participation rates (20–64)	77.4	81.7	84.1	84.5	82.0
Unemployment rate	9.8	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.2	17.4	18.4	21.3	26.1

In order to ensure compatibility and comparability across the EU Member States and taking into account the time-consuming nature of the methodology preparation process, the Ageing Report of the Economic Policy Committee is based on the actual data up to 2004, but starting from 2005 the demographic and macroeconomic assumptions are forecasts. This allows the first comparisons of the scenario with the actual developments in 2005 and 2006. The first analysis reveals that the actual macroeconomic indicators and the development of ageing-related expenditure have been better than planned, whereas the demographic development slightly worse. Overall, it suggests that the long-term sustainability risk assessment based on the EPC Report, is adequate and could further improve. Yet at the same time, it has to be admitted that the decrease of ageing-related expenditure (% of GDP) has not been fully reflected in the general government budget balance in these years.

7. Institutional Features of Public Finances

7.1. General description

The Constitution of the Republic of Latvia (*Satversme*) stipulates that the Parliament (*Saeima*) decides on the central government expenditure and revenue budget every year, before the start of the next financial year. The draft budget is submitted to the Parliament by the Cabinet. The budgetary process consists of four main stages, i.e. **drafting of the budget, discussion of the draft budget and approval on legislative level, budget execution and implementation monitoring**. The process of budget formulation, execution and monitoring is governed by the Law on Budget and Financial Management as well as other related legislative acts (Cabinet regulation, instructions, methodologies etc.).

The drafting of the budget commences in spring, when the Ministry of Finance, in consultation with the Ministry of Economy and the Bank of Latvia, prepares the medium-term macroeconomic development and fiscal policy scenario. Based on the developed scenario, tax revenue forecasts are prepared.

Every year, before the formulation of the next year's budget the government decides on the most important spending priorities as well as sets the maximum expenditure amount allowable for each ministry based on information about the forecast revenue. The Ministry of Finance informs ministries and other central government institutions about the basic principles to be applied in drafting the budget proposals, the basic principles of medium-term expenditure planning, the medium-term forecast of economic outlook as well as the financial restrictions to be complied with when preparing the budget estimates. Ministries, other central government institutions and their subordinated institutions plan expenditure broken down by programme and sub-programme, where each programme and sub-programme comprises measures aimed at achieving a specific objective.

The draft law on central government budget and explanations thereof are submitted to the Cabinet in September. In case of any issues that have not been resolved in the process of reviewing the budget proposals, these are submitted by the heads of the relevant line ministries to the Cabinet for review. After the draft budget has been reviewed by the Cabinet, the Cabinet decides on submission of the draft law on central government budget to the Parliament.

The Cabinet submits the annual draft law on central government budget, explanations thereof to the Parliament for adoption, accompanied by a package of related draft laws and medium-term development and fiscal policy framework by October 1 of the current year. After the budget law is approved by the Parliament, it is signed by the President of the Republic of Latvia.

The next stage of the budget process is budget execution. It consists of collecting the planned revenue and incurring expenditure in compliance with the provisions of the law on budget. The main institutions in charge of ensuring budget execution are the Treasury and the State Revenue Service. Each budget institution plans the spending of the appropriation granted to it by way of an estimate. The budget institutions have the responsibility to ensure that the actual expenditure does not exceed the planned expenditure, thus ensuring efficient spending of the financing. When the financial year has ended, the government prepares a report on central government budget execution and submits it to the Parliament for reviewing, together with an opinion of the State Audit Office. The State Audit Office's opinion addresses the compliance of the budget institution's spending with the reported data, highlights any gaps and provides recommendations for eliminating them. The concerned budget institutions prepare an action plan for implementation of the State Audit Office's recommendations.

In order to increase the accountability of budget institutions for efficiency and effectiveness of spending, in 2005 a provision was incorporated into the Law on Budget and Financial Management stipulating that ministries and other central government institutions submit an informative report on spending of the central government budget funding granted in the reporting year, on achievement of the performance indicators for the implemented policies and operational results and a clarification of any deviations from the approved performance indicators of programmes and sub-programmes to the Cabinet.

In order to inform the community about the objectives and results of an institution's operation as well as the spending of the central government budget funds granted in the previous year, ministries and other central government institutions and all their subordinated institutions financed from the central government budget as well as local governments prepare annual public reports by 1 July of the year following the reporting year.

Economic development trends are analysed regularly and an assessment of the potential impact on the central government budget revenue is prepared. It has to be realised that slow economic growth may cause the budget revenue to shrink, while the central government expenditure remains unchanged. With a view to this potential adverse impact caused by sluggish economic development, a special procedure has been stipulated in the Latvian legislation. Pursuant to Part II of Article 25 of the Law on Budget and Financial Management, the Minister of Finance reports on the required suspension or reduction of expenditure allocations, if it is expected that the central government deficit will exceed the target deficit approved in the annual state budget law. Within seven days of receiving the report, the Cabinet decides on suspension or reduction of allocations and no later than within three working days submits proposals concerning amendments to the annual state budget law to the Parliament for review.

In the course of government budget formulation, negotiations between the Latvian Association of Local and Regional Governments (hereinafter – LALRG) and the Ministry of Finance are held. As a result, a document highlighting the issues of dispute between the Cabinet and the LALRG and documenting their agreement is drafted. This draft statement is reviewed at a Cabinet meeting. It is obligatory to attach the statement of disputes and agreement between the Cabinet and the LALRG to the draft budget of the next year, when the government submits it to the Parliament.

7.2. Medium-term budgeting

On 14 September 2006, the Cabinet of Ministers supported the concept "On Introduction of Strategic Planning and Medium-Term Budgeting in Public Administration" (hereinafter – the concept), proposing solutions for improvement of medium-term budgeting in Latvia.

According to the concept, a three-year macroeconomic development and fiscal policy framework will be prepared starting from 2008. The framework will consist of the law on budget for one year and maximum spending limits from the central government budget for each ministry and other central government institutions for the next two financial years.

Starting from 2008, it is also planned to introduce an appropriation reserve, i.e. an appropriation in the central government basic budget that ministries, other central government institutions and local governments will be able to use under a specific procedure mainly on completing procurement procedures that have been planned in the annual law on central government budget, have started but have not been completed due to reasons beyond the control of the budget executor, Public Investment Programme projects and projects co-financed by the European Union.

Starting from the 2008 government budget, the Cabinet will have the rights to reallocate the appropriations established for a ministry or other central government institutions in the annual law on central government budget across programmes, sub-programmes and economic classification codes within the limits of the set appropriation.

In order to fully implement the medium-term budgeting starting from the 2008 budget, currently the drafting of the required legislation is ongoing. The first stage in implementation of the concept was the development of the draft law "Amendments to the Law on Budget and Financial Management". The main objective of amendments to the law was to provide the legal framework for introduction of the medium-term budgeting in public administration. Based on the delegation stipulated by the law, Cabinet of Ministers regulations required for implementation of the concept will be prepared in the course of 2007.

In order to achieve more effective and efficient spending of the available budgetary funds and ensure continuation of the already ongoing programme implementation, ministries introduce strategic planning, which will ensure that the budget is oriented towards financing of objectives and results. In 2006, the ministries and secretariats of special assignment ministries prepared operational strategies of their institutions (IOS).

In the context of introducing the medium-term budgeting, the public administration needs to improve the system of results and performance indicators, whose operational principles have been approved by 13 March 2003 Cabinet of Ministers decree No. 162 "On the Key Concepts of the System of Performance Indicators". Currently, the Minister of Finance has established a working group, which will improve the system of results and performance indicators based on the provisions of the concept. The working group incorporates representatives from the Ministry of Finance, State Chancellery, Ministry of Justice, Ministry of Economy, Ministry of Agriculture and the Treasury.

The State Chancellery has also currently begun to update the “Methodology Recommendations for Development of an Institution’s Operational Strategy” approved by the Cabinet on 12 March 2003, which were previously used as a basis for the IOS development. This is important, considering that the methodology recommendations will be used when working on further IOS updates as well as when developing the IOS already for the next planning period (2010–2013) at all levels of public administration, as it is stipulated in the Policy Planning System Development Guidelines. At the same time, the IOS is the primary source for the results and performance indicators of institutions.

Annex

Table 1a. Macroeconomic prospects

	ESA code	2005	2005	2006	2007	2008	2009
		millions of lats	rate of change, %				
1. Real GDP (at 2000 prices)	B1*g	7016.9	10.2	11.5	9.0	7.5	7.5
2. Nominal GDP	B1*g	8937.3	20.4	22.7	17.1	14.0	12.4
Components of real GDP							
3. Private consumption expenditure	P3	4518.0	11.4	17.0	12.1	7.6	7.5
4. Public consumption expenditure	P3	1108.4	2.7	3.0	3.0	2.5	2.5
5. Gross fixed capital formation	P51	2391.9	18.6	18.2	10.5	10.0	9.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+P53	24.9	4.4	8.8	8.2	7.1	6.2
7. Exports of goods and services	P6	3113.4	20.7	8.6	11.6	9.1	8.8
8. Imports of goods and services	P7	4139.8	13.5	18.0	11.0	8.7	8.1
Contributions to real GDP growth							
9. Final domestic demand		-	13.6	17.6	12.4	9.3	8.9
10. Changes in inventories and net acquisition of valuables	P52+P53	-	-4.0	0.7	-1.5	-0.3	-0.1
11. External balance of goods and services	B11	-	0.7	-6.8	-1.9	-1.5	-1.3

Table 1b. Price developments

	ESA code	2005	2005	2006	2007	2008	2009
		level	rate of change, %				
1. GDP deflator			9.2	10.0	7.5	6.0	4.5
2. Private consumption deflator			7.0	6.5	6.5	5.9	4.9
3. HICP			6.9	6.6	6.4	5.2	4.2
4. Public consumption deflator			6.4	6.0	6.0	6.0	6.0
5. Investment deflator			10.0	12.0	7.5	7.0	4.5
6. Exports price deflator (goods and services)			9.0	7.0	5.0	3.5	3.5
7. Imports price deflator (goods and services)			11.0	9.5	5.5	3.0	3.0

Table 1c. Labour market developments

	ESA code	2005	2005	2006	2007	2008	2009
		level	rate of change, %				
1. Employment, persons, thousands		1036	1.8	5.0	1.5	1.0	0.5
2. Employment, hours worked[8]		1890	-0.2	0.2	0.2	0.2	0.2
3. Unemployment rate (%)			8.7	6.9	6.6	6.3	6.0
4. Labour productivity, persons			8.3	6.2	7.4	6.4	7.0
5. Labour productivity, hour worked[8]			10.5	11.3	8.8	7.3	7.3
6. Compensation of employees, millions of lats, current prices	D.1	3480.4	18.7	29.4	17.6	14.5	12.9

[8] EU Commission estimate

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of world	B.9	-11.4	-17.4	-17.2	-16.3	-15.8
of which.: - Balance of goods and services		-15.3	-20.8	-20.7	-20.0	-19.3
- Balance of income and transfers		2.6	2.1	2.2	2.3	2.1
- Capital account		1.3	1.3	1.3	1.4	1.4
2. Net lending/ borrowing of the private sector	B.9/ EDP B.9	-11.5	-17.0	-15.9	-15.4	-15.4
3. Net lending/ borrowing of the general government	EDP B.9	0.1	-0.4	-1.3	-0.9	-0.4
4. Statistical discrepancy		-2.0	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

		2005	2005	2006	2007	2008	2009
	ESA Code	millions of lats	% of GDP				
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	11.6	0.1	-0.4	-1.3	-0.9	-0.4
2. Central government	S.1311	-109.2	-1.2	-2.2	-2.7	-2.0	-1.5
3. State government	S.1312	-	-				
4. Local government	S.1313	1.7	0.0	0.1	0.1	0.1	0.1
5. Social security funds	S.1314	119.1	1.3	1.8	1.3	1.0	1.0
General government (S.13)							
6. Total revenue	TR	3232.8	36.2	37.5	38.2	38.6	39.0
7. Total expenditure	TE	3221.2	36.0	37.9	39.5	39.5	39.4
8. Net lending/borrowing	EDP B.9	11.6	0.1	-0.4	-1.3	-0.9	-0.4
9. Interest expenditure[9]	EDP D.41	51.0	0.6	0.5	0.5	0.5	0.5
10. Primary balance		62.6	0.7	0.2	-0.8	-0.4	0.1
Selected components of revenue							
11. Total tax (11=11a+11b)		1840.9	20.6	21.4	21.9	22.3	22.4
11a. Taxes on production and imports	D.2	1126.0	12.6	12.8	13.4	13.7	13.8
11b. Current taxes on income, wealth etc	D.5	714.9	8.0	8.6	8.5	8.6	8.6
12. Social contributions	D.61	777.9	8.7	8.8	8.4	7.7	7.5
13. Property income	D.4	63.3	0.7	0.6	0.4	0.4	0.4
14. Other[10]		550.7	6.2	6.7	7.5	8.2	8.7
15. Total revenue	TR	3232.8	36.2	37.5	38.2	38.6	39.0
Tax burden (D.2+D.5+D.61+D.91 – D.995)[11]		2645.5	29.6	30.5	30.6	30.3	30.2
Selected components of expenditure							
16. Collective consumption	P.32	779.3	8.7	12.7	14.2	14.4	13.9
17. Total social transfers	D.62 + D.63	796.4	8.9	7.9	7.4	7.4	6.9
17a. Social transfers in kind	D.63	9.6	0.1	0.1	0.1	0.1	0.1
17b Social transfers other than in kind	D.62	786.8	8.8	7.8	7.4	7.3	6.9
18.=9. Interest expenditure	EDP D.41	51.0	0.6	0.5	0.5	0.5	0.5
19. Subsidies	D.3	44.0	0.5	0.6	0.2	0.2	0.2
20. Gross fixed capital formation	P.51	205.4	2.3	3.0	3.7	4.3	5.1
21. Other		1345.1	15.1	13.1	13.4	12.7	12.8
22.=7. Total expenditure	TE	3221.2	36.0	37.9	39.5	39.5	39.4
Pm: compensation of employees	D.1	904.6	10.1	9.5	9.2	8.9	8.7

[9] excluding FISIM
[10] including D.91
[11] including tax collections transferred to the EU budget

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	2009
1. General public services	1	4.6	4.8
2. Defence	2	1.2	2.0
3. Public order and safety	3	2.2	2.9
4. Economic affairs	4	4.7	4.8
5. Environmental protection	5	0.8	1.8
6. Housing and community amenities	6	0.8	0.8
7. Health	7	4.0	5.5
8. Recreation, culture and religion	8	1.4	1.8
9. Education	9	6.0	5.8
10. Social security	10	10.2	9.2
11. Total expenditure	TE	35.8	39.4

Table 4. General government debt developments

% of GDP	ESA code	2005	2006	2007	2008	2009
1. Gross debt		12.1	10.7	10.5	10.6	9.4
2. Change in gross debt ratio		-2.4	-1.4	-0.2	0.1	-1.2
Contribution to changes in gross debt						
3. Primary balance		-0.7	-0.2	0.8	0.4	-0.1
4. Interest expenditure	D41	0.6	0.5	0.5	0.5	0.5
5. Stock-flow adjustment		0.2	0.4	0.1	0.5	-0.4
of which: - Differences between cash and accruals		0.6				
- Net accumulation of financial assets		-0.5				
of which: *privatisation revenue*		-0.1				
- Valuation effects and other		0.1				
p.m. implicit interest rate on debt		4.7	5.5	5.7	5.7	5.4
Other relevant variables						
6. Liquid financial assets		1.9				
7. Net financial debt (7=1-6)		10.2				

Table 5. Cyclical development

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Real GDP growth (%)	B1g	10.2	11.5	9.0	7.5	7.5
2. Net lending of general government	B9	0.1	-0.4	-1.3	-0.9	-0.4
3. Interest expenditure	D41	0.6	0.5	0.5	0.5	0.5
4. Potential GDP growth (%)		9.2	9.7	9.0	8.5	8.0
contributions:						
- labour		1.3	1.6	0.9	0.4	0.2
- capital		3.9	4.2	4.4	4.4	4.2
- total factor productivity		3.8	3.7	3.5	3.4	3.4
5. Output gap		0.2	1.8	1.8	0.8	0.4
6. Cyclical budgetary component		0.1	0.5	0.5	0.2	0.1
7. Cyclically-adjusted balance (2-6)		0.0	-0.9	-1.8	-1.1	-0.5
8. Cyclically-adjusted primary balance (7-3)		0.6	-0.4	-1.3	-0.6	0.0

Table 6. Divergence from previous update

	ESA code	2005	2006	2007	2008	2009
Real GDP growth (%)	B1g					
2005		8.4	7.5	7.0	7.0	-
2006		10.2	11.5	9.0	7.5	7.5
Difference		1.8	4.0	2.0	0.5	-
General government net lending (% of GDP)	B.9					
2005		-1.5	-1.5	-1.4	-1.3	-
2006		0.1	-0.4	-1.3	-0.9	-0.4
Difference		1.6	1.1	0.1	0.4	-
General government gross debt (% of GDP)						
2005		13.1	14.9	13.6	13.7	-
2006		12.1	10.7	10.5	10.6	9.4
Difference		-1.0	-4.2	-3.1	-3.1	-

Table 7. Long-term sustainability of public finances

% of GDP	2004	2010	2020	2030	2050
Total expenditure	36.2	39.0	38.9	40.3	40.5
Of which: age-related expenditures	17.2	13.8	13.8	15.1	15.3
Pension expenditure	6.8	4.9	4.9	5.6	5.6
Social security pension	6.8	4.9	4.9	5.6	5.6
Old-age and early pension	5.7	4.3	4.3	4.9	4.9
Other pensions (disability, survivors)	1.1	0.6	0.6	0.7	0.6
Occupational pensions (if in general government)					
Healthcare	5.1	5.3	5.4	5.5	5.9
Long-term care	0.4	0.4	0.4	0.4	0.5
Education expenditure	4.6	3.3	3.1	3.5	3.3
Other age-related expenditures	0.33	0.3	0.2	0.2	0.2
Interest expenditure					
Total revenue	35.3	39.0	38.6	38.4	38.5
Of which: from pension contributions	7.1	6.1	5.6	5.4	5.4
Pension reserve fund assets					
Of which: consolidated public pension fund assets (assets other than government liabilities)					
Assumptions					
Labour productivity growth	6.4	6.5	4.0	2.7	1.1
Real GDP growth	7.5	7.4	2.9	2.1	0.4
Participation rate males (20–64)	83.4	87.6	89.6	89.5	87.6
Participation rate females (20–64)	71.9	76.2	79.0	79.8	76.6
Total participation rate (20–64)	77.4	81.7	84.1	84.5	82.0
Unemployment rate	9.8	7.6	7.0	7.0	7.0
Population aged 65+ over total population	16.2	17.4	18.4	21.3	26.1

***Table 8. Basic assumptions*[12]**

	2005	2006	2007	2008	2009
Short-term interest rate (LVL) (annual average)	3.1	4.4	5.0	5.0	5.0
Long-term interest rate (LVL) (annual average)	3.6	4.3	4.5	4.5	4.5
USD/EUR Exchange rate (annual average)	1.24	1.25	1.28	1.29	1.29
Nominal effective exchange rate, % change	-5.0	-0.4	0.0	0.0	0.0
World excluding EU, GDP growth	5.6	5.7	5.2	5.2	5.2
EU GDP growth	1.7	2.8	2.3	2.4	2.4
Growth of relevant foreign markets	9.0	9.6	8.6	7.8	7.8
World import volumes, excluding EU	7.1	9.0	8.2	7.9	7.9
Oil prices (Brent, USD/barrel)	54.1	66.1	67.6	68.4	68.4

[12] Technical assumptions